THE FREEMAN

IDEAS ON LIBERTY

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On the Foundations of Economic Liberty

Penalty of Surrender

SEPTEMBER 1988

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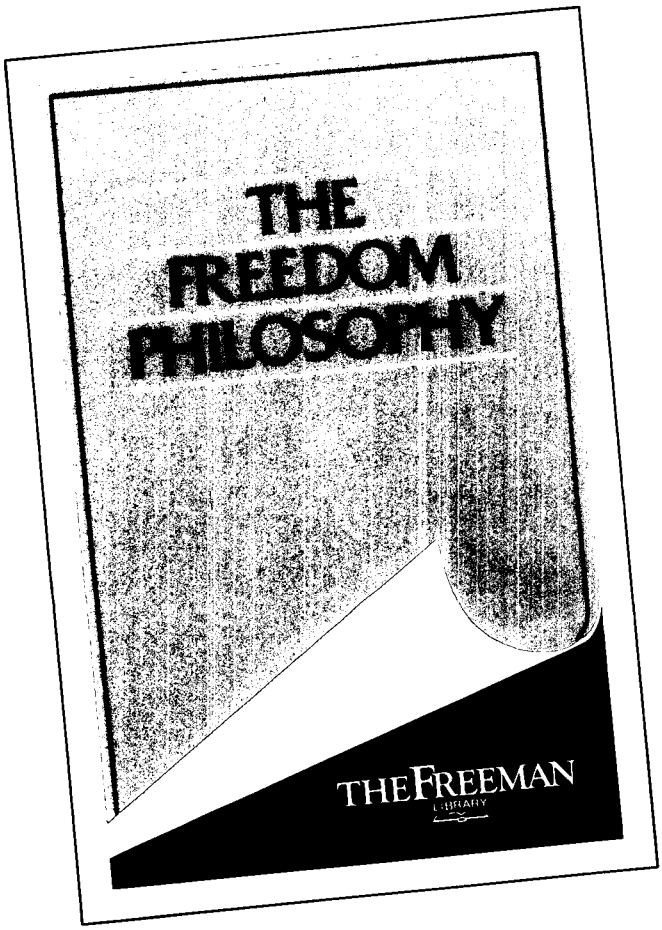

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IDEAS ON LIBERTY

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IDEAS ON LIBERTY

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PERSPECTIVE

Bruce M. Evans

The Power of Principle

Consistency of thought and behavior is indeed rare. The vagaries of life often are characterized by a continual shifting of principles and practices "to meet the demands of our modern world." There is today, perhaps as always, a dearth of exemplars of principled life—role models of internal and social consistency and integrity.

The 90th anniversary of Leonard Read's birth reminds us of a lifetime devoted to the practice and promotion of principled freedom. Through The Foundation for Economic Education, Mr. Read devoted almost 40 years to describing and calling for an ideal. He took the time and exerted the effort to analyze daily activities—personal, social, and political—in the context of principles and moral philosophy.

It seems somewhat ludicrous that we readily accept group action which would be considered unconscionable if initiated by individuals. Yet, the political agenda is generally shaped by special interest focus on outcomes with little thought for the violation and destructive abandonment of principles. Rarely do we ask, "Is this morally right?" in a discussion of proposed legislation. Our preoccupation is rather with good intention and popular appeal. Thus, unprincipled behavior often becomes the law of the land through action without thought and the anonymity of group process. In the absence of principle, power rules.

FEE continues to carry the banner for principled lives, public and private. The example and

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heritage provided by Leonard Read require our thoughtful perseverance in a cause served best by responsible, principled individuals.

—BRUCE M. EVANS
President

"I, Pencil" Gets Around

In December 1958, FEE's founder and longtime president, Leonard E. Read, wrote a short piece about an ordinary wooden lead pencil. He wrote in the first person, as if the pencil itself were writing. "I, Pencil," he wrote, "am a complex combination of miracles: a tree, zinc, copper, graphite, and so on. But," the pencil continued, "to these miracles which manifest themselves in Nature an even more extraordinary miracle has been added"—the "miracle" of uninhibited creative energy, bringing together millions of tiny know-hows of countless individuals. No human being could mastermind the complexities of making a pencil, Read wrote, any more than he could put molecules together to create the tree which is cut into small slats from which pencils are formed.

Read's explanation of the complicated division of labor and international cooperation required to produce something as simple as a pencil has struck a responsive chord with many people all over the world. "I, Pencil" has been reprinted in anthologies for school children, translated into foreign languages, and parodied in an ad several years ago in *Review of the News*. A diagram of a pencil was used by Hillsdale College, with quotes from the article, to illustrate why the free market is essential. Milton Friedman mentioned "I, Pencil" in his 1980 TV series, *Free to Choose*, and in his book of the same name. Thomas Sowell referred to it in his profound and thoughtful *Knowledge and Decisions*, when he wrote, "It has been said that no one knows how to make even a simple lead pencil."

"I, Pencil" has even been used in a recent best-selling Japanese comic book, *Japan Inc., Introduction to Japanese Economics*, which has been translated into English and is now available in this country. Several panels describe the ingredients, the tools, and the international cooperation needed to make a pencil. Then the legend reads, "It's not that each person works for the sake of making pencils. All of them work for the goods they want. . . . we make the goods they want so they'll make the pencils we want. . . . It's not that someone somewhere gives an order. Pencils are made right before our eyes, but it seems like a miracle."

—BBG

The Loss of Freedom

Much of the loss of freedom with the growth of big government has been concealed because the direct losses have been suffered by intermediary decision-makers—notably businessmen—and it is only after the process has gone on for a long time that it becomes blatantly obvious to the public that an employer's loss of freedom in choosing whom to hire is the worker's loss of freedom in getting a job on his merits, that a university's loss of freedom in selecting faculty or students is their children's loss of freedom in seeking admission or in seeking the best minds to be taught by.

—THOMAS SOWELL
Knowledge and Decisions

While They Starve

The Government of Ethiopia has so severely restricted emergency relief operations in the country's north, a region ravaged by both drought and war, that as many as two million people are out of reach of any known system of food distribution, aid officials and Western diplomats say.

Because of the restrictions, these officials say, hundreds of thousands of tons of donated food are piling up at ports and may never reach those in need. Agricultural seeds, too, are not being distributed. This means that farmers who must soon plant crops cannot do so, which could lead to even greater problems next year.

—*The New York Times*,
April 29, 1988

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THE FREEMAN
IDEAS ON LIBERTY

Penalty of Surrender

by Leonard E. Read

Editors' Note:

Leonard E. Read founded The Foundation for Economic Education in 1946 and served as its President until his death in 1983. He was a philosopher, teacher, and exemplar.

It is difficult to measure the full influence of Leonard Read. He wrote more than two dozen books and hundreds of articles, delivered over a thousand lectures, and changed more lives than any of us ever will realize. In trying to assess his personal impact, perhaps it is best to say that Leonard Read taught us what is important. Principles are important. Moral philosophy is important. And, as he showed by the example of his own life, courage and an abiding faith in one's convictions are important.

On this, the 90th anniversary of Leonard Read's birth (September 26, 1898), we are pleased to publish this article which first appeared in the April 1957 issue of The Freeman.

A certain business leader, perhaps among the most publicized during the last two decades, once severely lectured me on my unswerving and uncompromising behavior. He charged that I saw things only in blacks and whites. He argued that practical life was lived in shades of grays, actually in the shadows of these two extremes. He suggested that I had a nice chance of "going far" in the world, if only I would become more pliable to the thoughts and actions of my fellows. He really wanted me to be more agreeable to his middle-of-the-road political theories.

The compromising attitude is exalted by many and deplored by only a few. Most current discussions are tempered with concepts of compromise and expediency.

Compromise, like many other words, has different meanings for different persons. I want to use the term in the sense of one of the definitions given by Webster: "The result or embodiment of concession or adjustment." I wish to show that compromise is potentially good when applied in a physical sense and that it has no application whatever in a moral sense.

For example, you and your wife are spending what is hoped will be a happy evening at home. She chooses to watch TV and you elect to explore Toynbee's *Study of History*. The scene appears peaceful as you sit side by side. But to you the TV is making a lot of distracting noise.

Here are all the possibilities for turning a cheerful evening into one of disharmony. But compromise can come to your aid. Your wife can decrease the noise of the TV to the point where she can still hear it, and you can move to some remote corner where you can comprehend Toynbee just as well as anywhere else. Harmony can thus be preserved by compromise.

Compromise in this sense is an adjustment of physical situations. It is the process by which conflicts are reduced to the point most satisfactory to all parties concerned. When thought of in this way, compromise is the great harmonizer, the attitude that makes living together—social life—a pleasure.

Indeed, the market place of willing exchange where tens of millions of transactions go on

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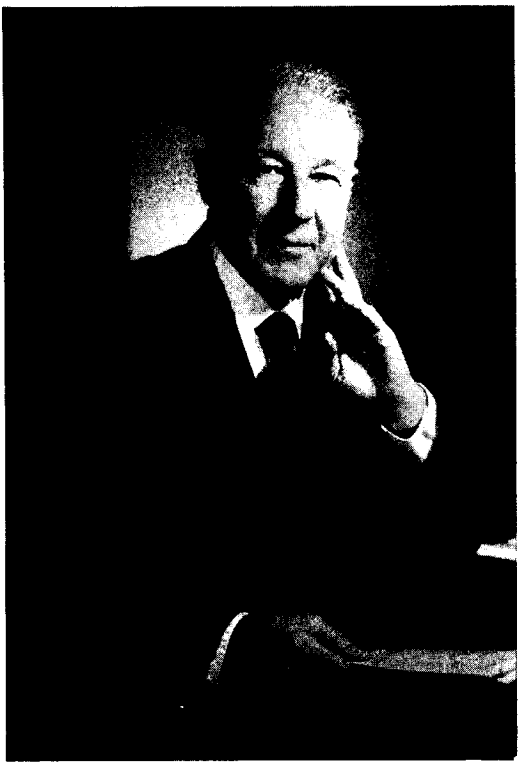

Leonard Read was born on a farm in Michigan. He claimed that his training in economics began at the tender age of eight. "My father started me milking cows while I was still a small boy. I learned the relationship between hard work and a quart of milk. All else in economics is but embellishment of this primary lesson."

At 19, Read's formal education was interrupted by his entry into World War I as an airplane mechanic with the American Expeditionary Forces. After the war, he sold insurance, worked as a cashier, then opened his own produce business. In 1927, he began a career in Chamber of Commerce work as secretary of one of the country's smallest Chambers. He was later manager of the Western Division of the Chamber of Commerce of the United States for 10 years. In 1939, he became general manager of the world's largest Chamber in Los Angeles. His work there won him the executive vice-presidency of the National Industrial Conference Board. He left the NICB in 1946 to organize FEE.

daily is one vast area of compromise. Buyers aim at low prices. Sellers aim at high prices. In a free market, unhampered by private thieves and political restrictions, there is an adjustment of these diverse desires. Compromise establishes the price at which the mutual satisfaction of buyer and seller is at its highest level.

It is in the physical realm that most of our daily life is lived. In this realm compromise is good and it is practical. It begets harmony and peace.

How easy it would seem then, finding compromise so useful in such a vast segment of life, to conclude thoughtlessly that it has an equal place, a comparable value, in that phase of life which consciously occupies little of our thoughts: moral life.

Principles Defy Compromise

But this is precisely the point where I believe many of us are the victims of a confusion of terms. What is compromise in physical affairs —that is, in an adjustment of physical positions—is something entirely different when applied to principles and morality.

For example, let us make the reckless assumption that most of us are committed to the Biblical injunction, "Thou shalt not steal." This is based on the moral principle that each person has the right to the fruits of his own labor. The point I wish to make—my major point—is that this *as a principle* defies compromise. You either take someone else's property without his consent, or you do not. If you steal just a bit—a penny—you do not compromise the principle; you abandon it. You surrender your principle.

By taking only *a little* of someone's property without his consent, as distinguished from taking a lot, you do compromise in the physical sense the amount you steal. But the moral principle, whatever the amount of the theft, is surrendered and utterly abandoned.

If all the rest of mankind is in favor of passing a law that would take the property, honestly acquired, of only one person against his will, even though the purpose be allegedly for the so-called social good, I cannot adjust myself both to the moral injunction, "Thou shalt not steal," and to the demand of the millions. Principle does not lend itself to bending

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or to compromising. It stands impregnable. I must either abide by it, or in all fairness, I must on this point regard myself as an inconsistent, unprincipled person rather than a rational, reasonable, logical one.

What Are Moral Principles?

The question immediately arises as to what constitutes principle. Here again is a term with varying meanings to different persons. I must, therefore, define what I mean.

The Ten Commandments are admonitions derived from the religious experience of an ancient people. In terms of their origin, the Commandments are cast in the form of intercepts of the will of God; in terms of their application, they are imperatives admitting of no dilution. They were expressions of principles at least to the ones who received them, and have been adopted as such by countless millions. Their acceptance springs from the studied deductions of the wiser among us, confirmed through centuries of observation and experience.

The correctness of a principle has little to do with the intensity of conviction with which a man holds it. Someone else may hold a contrary principle with like intensity. No man can get nearer to the truth than his own highest apprehension of it. Ultimate insights may differ, and such differences will always be part of the human scene. But there is another type of difference which is more pertinent to the point of this essay: the difference between those who accept unyieldingly a moral principle as their standard, and those who accept a principle watered down by "practical" considerations. Lord Morley warned of this danger when he deplored the tendency to forget the principle itself in our preoccupation with the practical difficulties of applying it.

To me "Thou shalt not steal" is a principled injunction not alone because some sage of antiquity said so, but largely because my own experience has compelled me to adopt this as a principle of right conduct which must be adhered to if I am not to destroy my own integrity, and if I am to live peacefully with my fellow men.

To those of opposite judgments, who believe that they should gratify their personal charitable instincts not with their own goods, but with goods extorted from others by the police force, who fail to see how thieving damages integrity, and who accept the practice of political plunder as right and honorable—to them, "Thou shalt not steal" must appear wrong in principle.

Sound Judgment Required

Whether a principle is right or wrong cannot in any ultimate or absolute sense be determined by any single one of us human beings. Principles on the level of human perception are what are judged to be the rules of life or nature; what are judged to be universal, eternal verities; what are judged to be fundamental points of reference. But, human judgment is fallible. Therefore, whether a stated principle is held to be right or wrong will depend on the quality of the individual's judgment. Aristotle claimed that there were a million ways to be wrong; only one way to be right. How easy for fallible beings to decide on a wrong way!

Sound judgment leads toward right principles. No person can rise above his best judgment, and he can rise only as fast as his judgment improves. On what, then, is an improving judgment dependent? My answer is: on revelation—"The disclosing or discovering . . . of what was before unknown . . ." Other terms for revelation are insight, cognition, inspiration, extrasensory perception. On what does revelation or insight rest? Surely, on conscious effort, education, the kind of persons with whom one associates, the topics selected for discussion, what one chooses to read—all of these relate to one's perception. More fundamental, however, than anything else is intellectual integrity, without which, I am certain, the cognitive stream cannot flow at its best. Goethe expressed the idea thus: "Nature understands no jesting; she is always true, always serious, always severe; she is always right, and the errors and faults are always those of man. The man incapable of appreciating her, she despises; and only to the apt, the pure, and the true, does she resign herself, and reveal her secrets."

Intellectual integrity simply means to reflect in word and in deed, always and accurately, that which one believes to be right. Integrity

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cannot be compromised. It is either practiced or not practiced.

Certainly, there is nothing new about the efficacy of accurately reflecting what one believes to be right. This principle of conduct has been known throughout recorded history. Now and then it has been expressed beautifully and simply. Shakespeare enunciated the principle when he had Polonius say:

> This above all: to thine own self be true,
> And it must follow, as the night the day,
> Thou canst not then be false to any man.

Edmond Rostand had the same principle in mind when he wrote for Cyrano:

> Never to make a line I have not heard in my own heart.

The Bible announces the penalty of surrender —what it means to abandon the truth as one sees it:

> The wages of sin is death.

Whether the wages of sin be mere physical death, as when men shoot each other over ideological differences, or profound spiritual death, as in the extinction of integrity, character, and self-respect, one needs to make but casual inquiry to verify the rightness of this Biblical pronouncement. Abundant testimony is being provided in our time. Nor is the end in sight.

Principles Surrendered

All the world is filled with examples of surrendered principles: men who know practically nothing about themselves trying to play God, attempting to control and forcibly direct the creative actions of others; the glamour of popularity and shallow earthly fame rather than the concepts of rightness directing the policies of nations; expediency substituting for the dictates of conscience; businessmen employing "experts" to help them *seem* right, often at the expense of rightness itself; labor leaders justifying any action that gratifies their lust for power; political leaders operating on the premise that the end justifies the means; clergymen preaching expropriation of property without consent in the name of the "common good"; teachers not explaining but advocating coercive collectivism; aspirants to public office building platforms from public opinion polls; farmers, miners, and other plunderbundists uniting with the police force to siphon unto themselves the fruits of others' labor; arrogance replacing humility; in short, surrender of principle appears to be the distinguishing mark of our time.

If we were suddenly to find foreign vandals invading our shores, vandals that would kill our children, rape our women, and pilfer our industry, every last man of us would rise in arms.

Yet, these ideas born of surrendered principles are the most dangerous vandals known to man. Is the Bible right that the wages of sin is death? Observe the growth of domestic violence. Note the extent to which the organized police force—government—promotes and enacts plunder rather than inhibits it. Scan the last 40 years of war, hot and cold; wars to end wars, each serving only as a prelude to larger wars. And, today, we worldlings, in angry and hateful moods, stand tense and poised to strike out at each other, not with shillelaghs, pistols, hand grenades, and cannons, but with mass exterminators of the germ and atom types, types that only a people of surrendered principles could concoct.

A Final Question: Is Honesty Dangerous?

Perhaps it is timidity that prevents many a man from standing squarely on his own philosophy and uttering nothing less than the highest truth he perceives. He fears the loss of friends or position. Actually, the danger lies in the other direction, in settling for less than one's best judgment.

Does it take courage to be honest? Does one have to be brave to express the truth as he sees it? Indeed, *it is not dangerous to be honest,* but rather a mark of intelligence. Being honest and adhering to principle requires intelligence more than courage. Courage without intelligence makes men blusterous and cantankerous with their views; they offend with their honesty. But, the villainy in that case is their cantankerousness, not their integrity.

Finally, some may contend that even if everyone were a model of intellectual integrity, by reason of the great variety of judgments,

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differences would still remain. This is true. But differences lead in the direction of truth in an atmosphere of honesty. Honest differences are livable differences.

Life in a physical sense is a compromise, a fact that need not concern us. But, when vast numbers of people surrender living by what they believe to be right, it follows that they must then live by what they believe to be wrong. No more destructive tendency can be imagined.

Honesty—each person true to his highest conscience—is the condition from which revelation springs; from which knowledge expands; from which intelligence grows; from which judgments improve. It is a never-ending, eternally challenging—a thoroughly joyous—process. Indeed, it *is* living in its higher sense. □

Leonard Read Changed My Life

by Jacob G. Hornberger

From the time I was a small child, I had planned to become an attorney. I never had any doubt that I would spend my entire life practicing law. Upon graduation from law school in 1975, I returned to my hometown to begin my long-awaited legal career.

Two years later I discovered *Essays on Liberty*, a series of books which The Foundation for Economic Education had published in the 1950s. It was there that I discovered the thoughts and ideas of Leonard E. Read, who had founded The Foundation in 1946. While I immediately recognized the tremendous significance of his message, it was not until years later that I realized that Leonard Read had changed my life forever.

When I was growing up, I learned certain important principles about the lives and property of other people. It was morally right to care for others, especially those in need. It was morally wrong to steal, no matter how well-intentioned. If I desired to assist others, I had to do so with my own efforts and resources, rather than with what I could take from others.

Soon after I began my legal career, I accepted a position on the Board of Directors of our local Legal Aid Society, a government agency whose purpose was to provide legal services to the poor. It seemed an excellent opportunity to use my legal background to assist people in need. Until I discovered the philosophy of Leonard Read, it never occurred to me that my attempt to help others in this way was fundamentally flawed.

Stealing cannot be made morally legitimate by legalizing it into a political system. If it is wrong for individuals to take the property of others, even to satisfy the urgent needs of the poor and disadvantaged, it is equally wrong to accomplish this through political representatives. Law is perverted when, instead of protecting property and choice, it is used to plunder property and manipulate choice. No matter how urgent the needs of others, the coercive redistribution of wealth is still morally

Mr. Hornberger is Director of Programs at The Foundation for Economic Education.

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wrong. The Legal Aid Society was providing legal assistance to the needy with resources that had been forcibly taken from others through the political process. Realizing that I was participating in this wrongful conduct, I resigned my position with Legal Aid.

After discovering Read's freedom philosophy, I could not understand why other people did not recognize the immorality of using the political system to take from some to give to others. As Read so aptly observed, no matter how honest and honorable people may be in their personal and business affairs, for some reason they are incapable of recognizing the immorality of a political system founded on plunder and control. The resulting tragedy is that while most persons live principled lives in their everyday activities, they live lives without principle with respect to their ideological beliefs.

What then can a person do most effectively to advance the cause of liberty? Since an individual is given only one life to reform and refine, each person should expend his efforts striving to improve himself rather than trying to change everyone else. To freedom devotees, this method of self-improvement means becoming so proficient at explaining the freedom philosophy that others who seek truth will become attracted to the devotee's ever-growing light of wisdom and understanding.

This process of self-improvement includes the personal maintenance of philosophical and practical purity with respect to the proper role of government. Leonard Read continually emphasized that principles can never be compromised; they can only be abandoned. Therefore, to maintain an ideal concept of government to which others will be attracted, it is imperative that each of us never advocate, or participate in, any political violation of liberty. This strict adherence to principle was summed up in Read's maxim, "No leaks!"

I did find one aspect of Read's writings very disconcerting. Underlying his entire philosophy was a belief in God. I simply could not understand how such an intelligent person, who had such brilliant insights into political theory, could actually believe such nonsense. Becoming quite exasperated with Read's conviction on this matter, I finally decided to investigate. It was not long after I began reading the Gospels that I discovered that Read was right about this aspect of life as well.

Leonard Read was a pioneer. While others were expressing the economic benefits of an unhampered market economy, Read was quietly presenting the moral case for freedom. It was this uncompromising, moral defense of liberty which ultimately changed the course of my life. □

Books by Leonard E. Read

Leonard Read wrote books on a wide range of social, economic, political, and moral issues—but always deeply concerned with the methods of freedom. Still in print—and available from FEE—are 18 of his books. Write to us for prices.

Accent on the Right
Anything That's Peaceful
Castles in the Air
The Coming Aristocracy
Deeper Than You Think
The Freedom Freeway
Having My Way
How Do We Know?
Let Freedom Reign
Liberty: Legacy of Truth
The Love of Liberty
The Path of Duty
Seeds of Progress
Talking to Myself
Then Truth Will Out
To Free or Freeze
Vision
Who's Listening?

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On the Foundations of Economic Liberty

by Roger Pilon

I. INTRODUCTION: TWO KINDS OF LIBERTY?

As the celebration of the bicentennial of our Constitution continues, we are coming increasingly to appreciate the connection between our economic liberties and our judiciary. It is a commonplace, of course, that enterprise has come under increasing restraint and regulation over the course of this century. In a review of yet another proposal to Federally charter the corporation, for example, L. E. Birdzell, Jr., writing in the bicentennial year of our independence, pointed to some 40 to 50 significant Federal statutes that "may reasonably be viewed as imposing requirements on corporate management in favor of employee, consumer, investor or environmental interests, ranging all the way to comprehensive regulation of entry, prices and services in much of the transportation, communication, energy, and banking industries."[1] The dozen years that have passed since that bicentennial have witnessed no appreciable measure of relief. On the contrary, in many areas the burdens upon enterprise have only increased, so much so that President Reagan, speaking from the Jefferson Memorial on the eve of last year's celebration of our founding, thought it fitting to call for an Economic Bill of Rights, which he later characterized as a "fundamental reform that sees to it that our economic freedom is every bit as protected as our political freedom."[2]

That the President was thus driven to distinguish economic from political freedom is a mark of our times, of course. Two hundred years ago one could scarcely imagine so peculiar a distinction, so entwined were economic and political liberty thought to be. Indeed, in the recently discovered working draft of the Bill of Rights, written by Roger Sherman in July of 1789, Article 2 declares that "[t]he people have certain natural rights which are retained by them when they enter into Society"; listed second in that Article, after rights of conscience but before rights of speech, writing, and publishing, are rights "of acquiring property, and of pursuing happiness & Safety,"[3] understood ordinarily as rights of pursuing economic well-being. In so conjoining economic and political liberties, as we would now speak, Sherman reflected simply the wisdom of his age. By way of evidence we need look no further than to John Locke, the philosophical father of our Revolution: "Lives, Liberties and Estates, which I call by the general Name, *Property*."[4]

There is more at issue here, of course, than a mere distinction, a semantic refinement. For behind this distinction is a set of ideas, a history of ideas—indeed, a whole vision that separates us from our forefathers. Yet the vision with which we are living today is increasingly being called into question: in economics, in law, in philosophy, the suspicion is developing that the Founders may have had the better of it—analytically, morally, and practically. A growing literature, pointing often to the opinions of our judiciary by way of evidence, is saying that along the way we lost our bearings.[5]

Roger Pilon is the Director of the Asylum Policy and Review Unit of the Department of Justice. *This essay is a slightly revised version of a speech Dr. Pilon delivered at the American Bar Association's Annual Meeting in San Francisco, California, on August 9, 1987, ABA Section of Corporation, Banking and Business Law Showcase Program: "Contract, Commerce and the Constitution—A Look at Economic Liberties and the Judiciary."*

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II. OUR IDEOLOGICAL ROOTS: INDIVIDUALISM

To explore these issues of ideology more fully, albeit briefly, we need to begin at the beginning, at our beginning, with the essence of the Founders' vision, nowhere set forth more clearly than by Thomas Jefferson in the Declaration of Independence. In the space of a mere seven phrases the Declaration distills the moral, political, and legal vision of the classical liberals, beginning, not surprisingly, on a point of epistemology, that the conclusions that follow are asserted not as empirical, much less as evaluative, but as "self-evident" truths, truths of reason. Far from the stuff of a living, evolving conception, these are the truths that speak eternally and unchangingly to the human condition, transcending both time and circumstance. The moral truths come first, beginning with the premise of moral equality: "that all Men are created equal, that they are endowed by their Creator with certain unalienable Rights, that among these are Life, Liberty, and the Pursuit of Happiness." Then come the political and, by implication, the legal truths: "that to secure these Rights, Governments are instituted among Men, deriving their just Powers from the Consent of the Governed." Finally, to make it clear that political power derives from and remains ultimately with the people, the Founders point to the right of the people to alter or to abolish their government and to institute new government in its place.

As has often been noted, what we have in these few, revolutionary phrases is nothing less than the inversion of the ancient order. No longer would politics come first, ethics second.[6] No longer would we begin with the group, the individual deriving his meaning, and his rights, from the group. No, we would begin instead with the individual. It is the individual who first has rights, which he has by nature, not by government grant. Indeed, it is government that gets its rights, or authority, by grant, from the individual, who yields up to government whatever rights he does, rights to be exercised on his behalf.[7] Thus it is that governments derive their *just* powers from the consent of the governed.

A. Political Legitimacy: Grounded in Consent

This final point—that to be just, government's power must be grounded in consent—marked a critical insight. Political legitimacy, the Founders were saying, is not a function of results but of process. It is not from the good deeds it does that government derives its legitimacy: if that were the case then the King's rule too would be legitimate, provided only that he produced good results—indeed, would be more legitimate than democratic rule if the results produced were better. No, political legitimacy has nothing at all to do with consequences, good or bad, but instead has everything to do with process. As with any ordinary contract, the distribution of power that results from the social contract will be legitimate only if the parties consent to that distribution. How else could individual autonomy, the right of the individual to rule himself, be respected and preserved unless the individuals over whom political power is exercised have consented to that exercise?

B. The Limits of Consent Theory

But if political legitimacy depends upon thus preserving individual autonomy, if powers of government are legitimate only if consented to, then a moment's reflection will suggest how difficult it is to establish political power that is morally legitimate. Because the argument here has been long known, if not widely known, let me simply summarize it.[8] It begins by amplifying the points just made, that if a particular grant of government power arises from unanimous consent, it is legitimate: that, after all, is precisely what "deriving their just powers from the consent of the governed" means. The problem arises when there is less than unanimous consent, which of course is almost always the case in the real world. For even if a supermajority consents, we are still left with the basic question: By what right does that ma-

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jority exercise power over the minority when the minority, by definition, has not consented? If consent is the foundation of political legitimacy, then political power exercised over a minority on behalf of the majority is simply illegitimate. Since the numbers per se carry no moral weight—we don't suddenly get legitimacy once we've gotten over the 50 per cent threshold—the majority is in no better position than the King when it comes to justifying its exercise of power over the minority.

The classical solution, of course, was by way of a social contract with two levels of consent. Turning once again to process, this solution provided that political power exercised with less than unanimous consent would be legitimate if but only if there had been prior unanimous consent to be bound by the outcomes of subsequent votes. We still need unanimous consent, that is, but only to get the government off the ground, to give it legitimacy in the first place. After that, whatever rules had been unanimously agreed to at the outset must be followed, including decision-making rules that enable subsequent adoption of other rules by less than unanimous consent. Thus on any given vote the minority could be legitimately bound by the result because it had previously agreed to be so bound. Indeed, this is precisely the theory that underpins our government, at least as between the states. Article VII of the Constitution reads as follows: "The Ratification of the Conventions of nine States, shall be sufficient for the establishment of this Constitution *between the States so ratifying the same*" (emphasis added). Satisfaction of this provision enabled the Constitution to get off the ground. But by implication, states not so ratifying could not have been bound by the subsequent decisions of ratifying states.

While this solution may have worked among the states, especially since all did vote to ratify, the problem it poses for individuals is of quite a different order: that problem, quite simply, is that in point of historical fact, no such prior unanimous consent by individuals can be located, not even in America, where we came closer to it than perhaps anywhere else in the world. Moreover, even if we could locate such primordial unanimous consent, if we take the individual seriously, as indeed we do, then the theory affords no solution at all to the problem of how to bind succeeding generations: those who in fact consented could be bound, but they could hardly bind their heirs.

Consent theory finds its last refuge, then, in the idea of "tacit" consent: even if we don't give explicit consent, this argument runs, by staying we implicitly bind ourselves. But the argument from tacit consent is plausible only if we don't press it. Once we do, the problem becomes apparent. For it amounts to the majority saying to the minority: "Come under our rule or leave." It amounts, that is, to the majority putting the minority to a choice between two of its entitlements: its right not to come under the rule of the majority—the very hurdle the majority has to overcome if its power is to be legitimate; and its right to stay where it is, free from the will of the majority. To argue otherwise, quite simply, is to beg the very question at issue, namely, how does the majority come to have authority, or legitimate power, over the minority? The argument from tacit consent, in short, is patently circular.

What this all comes down to, then, is not a little disturbing to those who have grown up with the belief that democracy is the final word in matters of political legitimacy. Democracy may indeed be the best word we have, but it is not the final word. For if legitimacy can be derived neither from results nor even, as a practical matter, from process, then we are left with the conclusion that government per se has a certain air of illegitimacy about it. Yet the Founders seem to have understood this point, however disturbing it may be to some today. As Professor William Stoebuck has written, Locke's social-contract theory, which says that "[g]overnment is a servant, necessary but evil, to which its subjects have surrendered only what they must, and that grudgingly, . . . was the accepted theory of government when the [Constitution] was being hammered out."[9] In sum, the Founders understood both the moral virtues and the moral limits of democratic rule.

C. The Solution: Limited Government

If government is a necessary evil, then, necessary largely because of the practical problems

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that surround attempts to secure our rights in a state of nature,[10] but evil because of the impossibility of satisfying the consent condition that alone would make it legitimate, what follows is as straightforward as it is compelling, namely, that government should be called upon to do no more than is necessary to enable it to carry out its principal purpose, securing our rights. From considerations of morality, from respect for the moral right of every individual to be free to live his own life, we may call upon government only in a limited way: we must settle, in short, for limited government, for to do otherwise is to violate the rights of those who ask only to be left alone.

The world that emerges from this vision is also straightforward. It is a world in which individuals are left free to pursue their own values, to live their own lives as they think best, to chart their own courses through life, alone or in association with others, free from government dictate or interference, provided only that in the process they do not violate the rights of others, which it is the business of government to prevent. Notice that there is no distinction here between economic and noneconomic pursuits. Why should there be? Provided, again, that they respect the rights of others, individuals or groups are free to pursue whatever ends they wish—artistic, entrepreneurial, political, eleemosynary, worthy or foolish. That, after all, is what freedom is all about. Notice too how different this conception of government is from the conception so common today: government is a necessary evil, instituted simply to secure our rights, not an instrument through which to pursue social goals, even worthy social goals. I will say more about this contrast shortly. For the moment, however, I want to draw very briefly a still sharper contrast, between the classical vision and the vision that is its polar opposite.[11]

III. THE OPPOSITE IDEOLOGY: COLLECTIVISM

A. Rights as a Product of Development

That opposite vision stems from Karl Marx, of course, at least in its modern version. In 1987 I had the privilege of attending the 43rd Session of the U.N. Human Rights Commission in Geneva, where I served as the political adviser to the head of the American delegation. Representing the Soviet Union at one point in those proceedings was Boris Kravtsov, the Soviet Minister of Justice, who told the assembly that in his country "insuring human rights was one of the main aims of social, political, and economic development." In so putting the matter, Mr. Kravtsov clearly was speaking of a very different conception of rights and of social organization than we have thus far been considering here. Rights, on this view, do not belong to individuals as such; rather, they are "by-products," if you will, of development. Indeed, Mr. Kravtsov went on to say: "Recently we gave certain collectives the right to participate in these developments." And again, "we are giving unions the right to participate in state and social life." Like the *ancien régime*, the Soviet government gives rights. Individuals do not have rights by nature; instead, they get them from government. And "government," Article 6 of the Soviet Constitution tells us, means the Communist Party.

What is most striking about this vision, because most fundamental, is that it begins not with the individual but with the group, as represented by the government, which inevitably means the Party. For all its pretense to historical progress, the system is thus a throwback to the ancient order, with the Party standing in the place of the King. The Party "determines the general perspectives of the development of society"—I quote here from Article 6 of the Soviet Constitution. As development progresses, presumably, "rights" to jobs, housing, and so on get distributed by the Party, all according to the plan. Social and economic development are thus conscious undertakings, centrally planned

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by the Party, in pursuit of which the individual is an instrument to be used.

B. Using the Individual for the Common Good

Setting aside the economic impoverishment that necessarily accompanies central planning, I want to focus here on the moral impoverishment this vision entails. It begins, of course, with the sublimation of the individual, with the assumption that the individual has no rights that his government has not first given him, and the implicit assumption that government has rights to give out in the first place. But in making rights a function of development, the burden, if rights are to be insured, is placed upon continuous development; for without it, there would be no rights. This means, however, that if individuals are to have rights they will be obligated to contribute to this centrally planned development, however out of their hands the decisions and planning of the development may be. What started out as a *right* to work, then, has suddenly become a *duty* to work. Indeed, as has often been noted, the central moral problem with socialism is that it *uses* people. It treats individuals as means, not as ends—to be used in carrying out the Party's development plan.

The socialist system thus violates the cardinal principle of ethics, as articulated by John Locke, by Immanuel Kant, by every great religion, that the individual is not to be used, is not to be treated as a means, but rather is to be treated as an end in himself. He has a right to be so treated, a right to what is his, a right to chart his own course through life, a right not to be chained to the pursuit of someone else's vision, whether Marx's, or Lenin's, or Stalin's, or the Central Committee's, or whoever's. To so chain him, to so use him in pursuit of the chimera of development is to deny him his right to choose for himself, to strip him of his inherent dignity, to deny him his fundamental right to be free. Is it any wonder that around the world people have fled and are continuing to flee from socialist systems? For in the end, individuals cannot but choose for themselves. Either they flee, often at great, even tragic personal cost, or they resign themselves to lives of quiet desperation, serving a master they did not choose, leading a life they could not wish.

Now I have drawn this contrast not because I believe that in the 200 years since our founding we have come close to the Soviet model—let me be clear about that—but because the contrast between the vision of the Founders and the vision that is Soviet reality sharpens our appreciation of the essential moral issues. At the same time, a number of disturbing parallels have developed over these 200 years, if not in scope at least in kind, so much so that a decade ago we heard much about the convergence thesis, the idea that in their social and political organization the two societies were converging. In this decade the convergence thesis seems to have waned—in part, no doubt, because there are many who have come to realize that the Soviet Union, by its very structure, is indeed an evil empire. Nevertheless, the not unrelated moral equivalency thesis remains very much alive in many quarters, the idea that as a moral matter there is not much difference between the two societies, suggesting a substantial measure of confusion as to what the moral issues really are. Let us return, then, to the Founders' vision to see what has happened along the way that might help to account for this confusion.

IV. THE DEMISE OF THE CLASSICAL VISION

A. The Democratic March: From Rights to Results

The first thing that happened, one could say, was the demise of the natural rights foundation on which the Founders' entire vision rested. David Hume, the Scottish philosopher who died in the year America was born, prepared the ground for that demise when he observed that from factual propositions no normative conclusions could be drawn,[12] an epistemological observation so startling that it awakened Kant from his dogmatic slumber, as he later put it. But while Kant was struggling mightily to

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restore the rational foundations of ethics, Jeremy Bentham, the father of British utilitarianism, was declaring that talk of moral or natural rights was "simple nonsense: natural and imprescriptible rights, rhetorical nonsense,—nonsense upon stilts."[13] Thus began the long emergence over the course of the nineteenth century and into the twentieth of utilitarianism, rooted not in reason but in values, which held that acts, or laws, or policies were just not by virtue of their respect for individual rights but by virtue of their serving to produce the greatest good for the greatest number. In America, especially as we worked our way into the twentieth century, utilitarianism had its counterpart in law in what Professor Robert Summers has called "pragmatic instrumentalism," the conception of law as an instrument for accomplishing social goals.[14] The Progressive Era was the intellectual seedbed for this view, although it reached fruition only with the New Deal.

By itself, however, pragmatic instrumentalism in law, even coupled with utilitarianism in ethics, could not have brought about this shift from rights to results. For results-based rationales of policy and law have always failed to deeply satisfy: first, because of the impossibility of computing the utilitarian calculus, owing to the incommensurability of interpersonal comparisons of utility;[15] second, because even if we could compute that calculus, we are still left with Hume's dilemma, that from factual knowledge of the greatest good for the greatest number it does not follow logically that we ought to pursue that good; and third, even if we could compute that calculus and could make that logical leap, we are left with a nagging doubt, even absent a well-grounded theory of rights, that pursuing that good, especially when doing so would be at the expense of some among us, would not be right, might even violate rights.

Enter, therefore, democratic theory, which emerged through the nineteenth and twentieth centuries as the handmaiden of utilitarianism and pragmatic instrumentalism. What democratic theory purported to supply was both a solution to the problem of making the utilitarian calculus—we find out what the greatest good for the greatest number is by taking a vote—and a moral rationale—democracy is merely the moral right of each to rule himself writ large. Armed with the explanatory and justificatory force of democratic theory, or so we believed, we could shift our focus from rights-based to results-based policy and law, we could shift from limited government, instituted to secure our rights, to expansive government, engaged to pursue our goals—we could shift, in short, from government as a necessary evil to government as an engine of good.

B. The Institutional Manifestation: Judicial Abdication

Because this shift, at bottom, was from a reason-based vision to a will-based vision, it is not surprising that as an institutional matter the locus of the evolution was in the Congress and the Executive, the will-based branches of government. With the growth of the democratic impetus and the increase in the scope of the franchise, the pressure grew to enact "the will of the people." Standing athwart this democratic engine over the years had been the judiciary, the reason-based branch of government. But even the judiciary was not immune to the march of ideas, especially in the absence of satisfactory countervailing ideas, and so in time it too joined in the procession, abandoning reason to will, nowhere captured more clearly, perhaps, than in Mr. Justice Holmes' famous dissent in the infamous *Lochner* case—or so the conventional characterization would have it.[16]

In *Lochner*, you will recall, the Court found that a New York State statute regulating the hours of employment of bakery workers violated the liberty of contract protected by the Fourteenth Amendment to the Constitution, prompting Holmes to declare, in dissent, that the case was "decided upon an economic theory which a large part of the country does not entertain" and to offer further that his "agreement or disagreement [with the theory] has nothing to do with the right of a majority to embody their opinions in the law."[17] Having thus characterized the Court's decision as grounded not on a legal and moral but on an economic theory, having then disparaged the

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Court for reading its economic philosophy into the Constitution, Holmes proceeded to read out of the Constitution all economic substance, saying that "a constitution is not intended to embody a particular economic theory, whether of paternalism and the organic relation of the citizen to the state or of laissez faire."[18] In so emptying the Constitution, Holmes ignored a number of its powerful substantive clauses, of course, from the takings, to the contracts, to the privileges and immunities, to the due process of law clauses, not to mention the histories of their enactment, which would have given additional weight to this substantive understanding.[19] And in place of a substantive reading he erected "the right of a majority to embody their opinions in law," which of course is nowhere to be found in the Constitution and indeed was carefully constrained by the Founders.

So powerful was this majoritarian impulse, however, that in time it prevailed even with the judiciary. By the time we reached *Carolene Products*[20] in 1938, following *Nebbia*[21] in 1934 and *West Coast Hotel*[22] in 1937, the distinction between economic and political liberties was finally established, as was the idea that these "different" rights should be subject to different levels of judicial review—the operational manifestation of the distinction. Once again, this distinction and its operational manifestation, like Holmes' "right of the majority," was nowhere to be found in the Constitution. But ignoring this and oblivious to the moral limitations inherent in democratic theory itself, yet driven by the unrestrained democratic vision, the Court simply abdicated its responsibility to protect the rights of the minority in their economic activities. Rights of democratic process would be protected, for this was what the unrestrained vision called for; but rights of economic substance would go unprotected, for deciding these was what the process was all about.[23]

V. THE MARCH OF IDEAS: RESTORING OUR ROOTS

Thus have we continued to the present, but there are signs that changes may be in the offing. In 1984, for example the Supreme Court decided a case called *Hawaii Housing Authority* v. *Midkiff*,[24] reversing a Ninth Circuit opinion that had found unconstitutional a Hawaii statute that permitted the state to condemn private land not so that it could be converted to public use but so that it could be purchased by private tenants who occupied it. What was noteworthy about this case was not the Supreme Court's opinion—far from it—but the Ninth Circuit opinion the Court reversed, which had held that "it was the intention of the framers of the Constitution and the Fifth Amendment that this form of majoritarian tyranny should not occur."[25] That language, together with the Supreme Court's opinion to the contrary, prompted an outpouring of critical comment, all of which may have played into the Supreme Court's more recent decisions in the land use area, at least to the extent that the Court remains susceptible to the march of ideas. I allude here to the *First English Evangelical Church*[26] and to the *Nollan*[27] decisions in 1987, both of which appear to be moving back toward a regime of restraint on public power over private individuals in the economic domain.[28]

And why should the judiciary not be susceptible to the march of ideas if indeed it is our reason-based institution. Earlier I noted that the rise of utilitarianism, pragmatic instrumentalism, and democratic theory was unaccompanied by satisfactory countervailing ideas. Well, that has changed in recent years. On the critical side, the idea that democracy affords a solution to the problem of deriving the utilitarian calculus has been exposed by the work of decision theorists, including those working in the area of public choice.[29] And in moral theory the idea that democratic rule is self-rule writ large has long been exploded, as earlier discussed. But on the constructive side also, much work has been done, aimed at developing the foundations for natural rights theory that admittedly were not there at our founding.[30]

All of which should encourage those judges who are disturbed by the march of the public domain to dip into this literature, the better to

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gain the intellectual confidence that is helpful when standing against this march.[31] For the ultimate outcome of the march of the public domain is not a pretty picture, as earlier outlined. When all is public then by definition there is no private domain, no place to go to escape the public demand, as those who manage to flee such regimes will attest. By the design of our system we depend upon an unelected judiciary to brake the democratic engine, to protect the right of the individual, alone or in association with others, to live his own life, free from tyranny, free even from majoritarian tyranny. That was the original vision. It continues today to be the only vision that can ultimately be justified. □

1. Birdzell, "Constitutionalizing the Corporation: The Case for the Federal Chartering of Giant Corporations," 32 *Bus. Law.* 317 (1976).

2. Remarks by President Reagan to the citizens of Port Washington, Wisconsin (July 27, 1987). White House Press Release.

3. "Handwritten Draft of a Bill of Rights Found," *The New York Times*, July 29, 1987, §A, at 1.

4. J. Locke, *The Second Treatise of Government* §123 (P. Laslett ed. 1966).

5. *See, e.g.*, B. Siegan, *Economic Liberties and the Constitution* (1980); *Economic Liberties and the Judiciary* (J. Dorn & H. Manne eds. 1987); *Public Choice and Constitutional Economics* (J. Gwartney & R. Wagner, eds. 1988).

6. *Cf.* Aristotle, *Nicomachean Ethics*, Bk. I, ch. 2.

7. *See* R. Nozick, *Anarchy, State, and Utopia* 6 (1974). *Cf.* the text at note 3, *supra*.

8. *See* Nozick, *supra* note 7; R. Wolfe, *In Defense of Anarchism* (1970).

9. Stoebuck, "A General Theory of Eminent Domain," 47 *Wash. L. Rev.* 553, 608 (1972).

10. These practical problems are surveyed in Locke, *supra* note 4, and Nozick, *supra* note 7.

11. The contrast that immediately follows draws from my monograph *Human Rights and Politico-Economic Systems*, the Cato Institute, Washington, D.C., 1988.

12. D. Hume, *Treatise on Human Nature*, 469–70 (Selby-Bigge ed. 1888).

13. J. Bentham, Anarchical Fallacies, in 2 *Collected Works* 501 (Bowring ed. 1843).

14. Summers, "Pragmatic Instrumentalism: America's Leading Theory of Law," 5 *Cornell L.F.* 15 (1978).

15. The classic attempt was by Henry Sidgwick, *The Methods of Ethics* (7th ed. 1907); *See* A. Donagan, *The Theory of Morality* (1977).

16. *Lochner* v. *New York*, 198 U.S. 45 (1905).

17. *Id.* at 75.

18. *Id.*

19. See especially Siegan, *supra* note 5; R. Epstein, *Takings: Private Property and the Power of Eminent Domain* (1985).

20. *United States v. Carolene Products Co.*, 303 U.S. 144 (1938).

21. *Nebbia* v. *New York*, 291 U.S. 502 (1934).

22. *West Coast Hotel* v. *Parrish*, 300 U.S. 379 (1937).

23. For a contemporary version of this view *see* J. Ely, *Democracy and Distrust* (1980).

24. 467 U.S. 229 (1984).

25. *Midkiff* v. *Tom*, 702 F.2d. 788, 790 (1983).

26. *First English Evangelical Lutheran Church of Glendale* v. *County of Los Angeles, California*, 107 S. Ct. 2378 (1987).

27. *Nollan v. California Coastal Commission*, 107 S. Ct. 3141 (1987).

28. For an outline of a resolution of the takings question *see* my "Property Rights, Takings, and a Free Society," 6 *Harv. J. L. Pub. Policy* 165 (1983).

29. *See, e.g.*, K. Arrow, *Social Choice and Individual Values* (2nd ed. 1963); Riker, "Implications from the Disequilibrium of Majority Rule for the Study of Institutions," 74 *Am. Pol. Sci. Rev.* 432 (1980); and the classic by J. Buchanan and G. Tullock, *The Calculus of Consent: Logical Foundations of Constitutional Democracy* (1962).

30. *See, e.g.*, A. Gewirth, *Reason and Morality* (1978). *Cf.* R. Pilon, *A Theory of Rights: Toward Limited Government* (1979) (Ph.D. dissertation, University of Chicago). For an application in the area of economic liberty, *see* Pilon, "Corporations and Rights: On Treating Corporate People Justly," 13 *Ga. L. Rev.* 1245 (1979).

31. I have discussed the issues of judicial review more fully in "On the Foundations of Justice," 17 *The Intercollegiate Rev.* 3 (1981); "Legislative Activism, Judicial Activism, and the Decline of Private Sovereignty," in *Economic Liberties and the Judiciary*, *supra* note 5, at 183.

Overbearing Majorities

IDEAS ON LIBERTY

"Wherever the real power in a Government lies, there is the danger of oppression. In our Governments the real power lies in the majority of the Community, and the invasion of private rights is *chiefly* to be apprehended, not from acts of Government contrary to the sense of its Constituents, but from acts in which the Government is the mere instrument of the major number of the Constituents."

—JAMES MADISON, *in a letter to Thomas Jefferson, October 17, 1788*

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The *Monitor*: America's Socialized Shipwreck

by Gary Gentile

For more than two centuries, Americans have defended the rights of sailors to move freely upon the open seas. But now, the international waters again are under attack. This time, however, we are fighting for freedom *under* the seas. And this time, the usurpers are minions within our own government.

At the center of the controversy lies the *Monitor*, one of the first ironclad warships, which was built for the Union navy by John Ericsson. Launched in January 1862, the *Monitor* was 179 feet long, weighed 1,200 tons, and featured a revolving turret containing two 11-inch guns. She was powered by steam, and had a screw propeller.

On March 8, 1862, the *Monitor* engaged the Confederate ironclad *Virginia* (formerly the *Merrimack*) near Hampton Roads, Virginia. In a historic struggle, the two ironclads fought a four-hour duel, which ended in a draw. In May 1862, when the Confederates abandoned Norfolk, the *Virginia* was run ashore by her crew and burned. In December 1862, the *Monitor* foundered and sank in heavy seas off Cape Hatteras, North Carolina. This, it would seem, was the end of the *Monitor* and *Merrimack*.

However, the U.S. Navy knew the approximate location of the *Monitor*. But without adequate financing for an in-depth survey, the Navy was unable to find the wreck.

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The Navy's primary concern was not who got credit for the find, but that the shipwreck be found. In 1953, to provide incentives for the private sector to conduct scanning operations, the Navy struck the vessel from the Naval Register and abandoned all salvage claims.

For two decades a veritable flotilla searched the shoals off Cape Hatteras, but it was not until 1973 that the Duke University research vessel *Eastward* located and tentatively identified the remains of the *Monitor* 16 miles offshore. The following year the site was revisited, and positive identification was obtained when the research vessel *Alcoa Seaprobe* took several thousand underwater pictures which were assembled into a photomosaic by Navy specialists.

Almost immediately, several government agencies began vying for control of the *Monitor* wreck. The winner was the National Oceanic and Atmospheric Administration (NOAA), under the auspices of the Department of Commerce. Although the ironclad did not fit the criteria of any Act of Congress, the Marine Protection, Research, and Sanctuaries Act was the shielding mechanism deemed most appropriate. The *Monitor* became a sanctuary in the middle of a one-mile diameter tract of sea bed and the accompanying column of water. It was designated the first marine sanctuary, and came to be known as the *Monitor* National Marine Sanctuary (MNMS). The *Monitor* had at last found a home—or was it a jail?

The *Monitor* as a marine sanctuary lies on shaky ground—and in legally turbulent water.

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By international agreement, territorial rights extend to 12 nautical miles from the mean high water mark. In this respect, the U.S. generously claims only three miles of territorial waters. In either case, the *Monitor* resides on land not owned by the U.S., and which is outside U.S. jurisdiction.

In addition, because the wreck was legally abandoned, its status falls under the common law principle of the maritime law of salvage, which, although expressed by various judges in different forms, generally provides that "the finder or salvor of abandoned property at sea who first reduces that property to his possession may keep that property." (*Treasure Salvors III* case) In the 1981 *Cobb Coin* case, U.S. District Court Judge James Lawrence King further stipulated that "salvage law permits one whose salvage efforts are continuous and reasonably diligent to work a wreck site to the exclusion of others." In other words, the backers of the *Eastward* expedition could have kept a substantial claim over the wreck had they continued to work it. Since they did not, the wreck is unclaimed property. Anyone may salvage it.

Anyone, that is, except U.S. citizens. They are not even allowed to look at the wreck, much less recover anything from it.

While the stipulated goals of the National Marine Sanctuary Program are, in part, to "enhance public awareness, understanding, and wise use of the marine environment," and to "provide for maximum compatible public and private use," the case of the lost shipwreck has been wrapped in rolls of extremely sticky red tape.

Frustration and Delay

Four years ago, when I first applied to the MNMS for a permit to dive the *Monitor*, it was with full confidence of receiving prompt and professional aid. My simple letter of intent stated my purpose and objectives—to dive the wreck of the *Monitor* in order to take pictures of the historic site. What I got was years of frustration and delay. At first, I received no response to my queries. Later, I obtained a grudging acknowledgment. Finally, intentionally rigid restrictions were imposed which would make compliance difficult and expensive. But, because I wanted to dive the wreck, I proceeded.

I wrote a six-page monograph, but MNMS found it inadequate. Eventually, this grew into a proposal of more than 100 pages in which I had to: itemize every piece of equipment I intended to take, and describe the function and use of each; submit a detailed cruise plan and time table of events; explain in intricate detail the techniques of scuba diving, even the most basic; furnish resumés and complete medical examinations for each participant; specify my goals, with no allowed deviation; and provide proof of funding. Doing this, I felt more like the board of directors of a university sponsoring an expedition than an individual desiring merely to see a sanctuary that supposedly had been put aside for my benefit.

During this time, not only did I receive no cooperation from MNMS, but the number of unanswered questions posed in my many letters was growing. And only one letter in four was answered. Worse, as I met the demands imposed upon me, the agency invoked discretionary procedures to conjure up more stumbling blocks.

In short, my permit application was denied. I was cited for safety violations due to depth (the *Monitor* lies in 220 feet of water) and for having photographic objectives which already had been met by previous NOAA expeditions. The *Monitor* National Marine Sanctuary took no cognizance of my experience and level of expertise: more than 700 open-ocean, decompression dives, of which nearly a hundred were made in depths equivalent to the *Monitor*.

In addition, MNMS officials assert that my photographic efforts on the *Monitor* must produce viable results which in some way benefit the Sanctuary. This obviates the ultimate aim of the sanctuary program: that sanctuaries, like parks, exist for the benefit of the people, not the reverse. Even if I chose not to make photographic documentation, this should not rule out my wanting to dive the *Monitor* because, like Mount Everest, "it is there."

Following administrative procedure, I appealed the denial.

But my involvement with MNMS did not

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end there. Because of my tenacity, I became the focus of an investigation. Upon learning that I intended to dive in North Carolina close to the *Monitor* site, a MNMS spokesman alerted the Coast Guard and threatened me with arrest and a $50,000 fine should I be caught within Sanctuary boundaries. This brought up a curious situation: despite numerous requests for precise navigational coordinates, which I had needed for my proposal to calculate running times from shore to wreck, MNMS had steadfastly refused to give them to me. Now it enjoined me to stay away from a spot whose location I did not know. Nevertheless, officers of the Marine Fisheries Department were waiting for my chartered boat every day when it docked. They inspected our gear for artifacts which might have been old enough to have come from the Civil War ironclad. The surveillance continues.

Denying Access

I once cajoled an MNMS spokesman into admitting that Sanctuary regulations had been made purposely stringent so as to deny public access. The MNMS desires sole proprietorship over the site; it wants to have the only photographs of the wreck; and it wants complete control over publicity. It does not want to share the *Monitor* experience. Not is it committed to having the wreck fully documented—it wants only that such documentation be generated within its own bureaucracy, free from outside competition.

The condition of the *Monitor* today is not the same as it was yesterday, last year, or at any other time in its history. The sea is ever changing, ever destroying. As a shipwreck disintegrates, it passes before our eyes like a movie in extreme slow motion. Each frame is ephemeral, existing only for a brief instant in time, and must be studied before it dissolves.

Even the most naive must admit that the *Monitor* does not display the same graceful curves as when it slid down the ways in 1862. Its turret and Dahlgren guns are no longer thrust out defiantly against foes such as the *Virginia*. Its destruction is a continuous and ongoing process that is not stopped by the passing of laws, or governmental intervention.

My case seemed totally lost until I met Peter Hess through the Atlantic Alliance for Maritime Heritage Conservation. This body of volunteers has lobbied for years against the many bills which seek to take, not just the *Monitor*, but all shipwrecks out of the public domain, and place them under government control. Although the prime goal of the Alliance is to teach underwater archaeology to interested divers around the nation, it has taken a staunch position in protecting people's rights to dive shipwrecks.

Peter Hess is a diver, shipwreck historian, amateur archaeologist, and an attorney with a background in maritime law. He has been intimately involved with diving legislation, has frequently advised on Alliance policy, and has testified in Senate hearings against the Abandoned Shipwreck Acts, which aim to place all shipwrecks under government control. He followed my *Monitor* pursuits with fervent concern. When my bid for justice died, he put life back into my sagging spirit.

After listening to my story and reading my correspondence, Peter was keen enough to note many improprieties in NOAA's handling of my permit application: improper delegation of authority, bias among MNMS staff members who had personal ambitions concerning the disposition of the *Monitor*, disinclination to consider proven scuba diving methods, and lack of impartial review. The denial of my permit was arbitrary and capricious.

Working together, we filed a complaint for declaratory judgment and injunctive relief in the United States District Court for the Eastern District of Pennsylvania. NOAA and MNMS were forced to commit to the administrative record such evidence as existed in their files. However, so vehemently did they resist interrogation that they filed a motion to have any further discoveries kept out of the Court's eyes.

Even so, several things became immediately clear: that, although mandated by Federal regulation, my permit application had not been circulated among members of either the Scientific Review Board or the Advisory Council on Historic Preservation—those very two committees for whom I had written my proposal in such painstaking detail; that, after stipulating that my photographic objectives already had been

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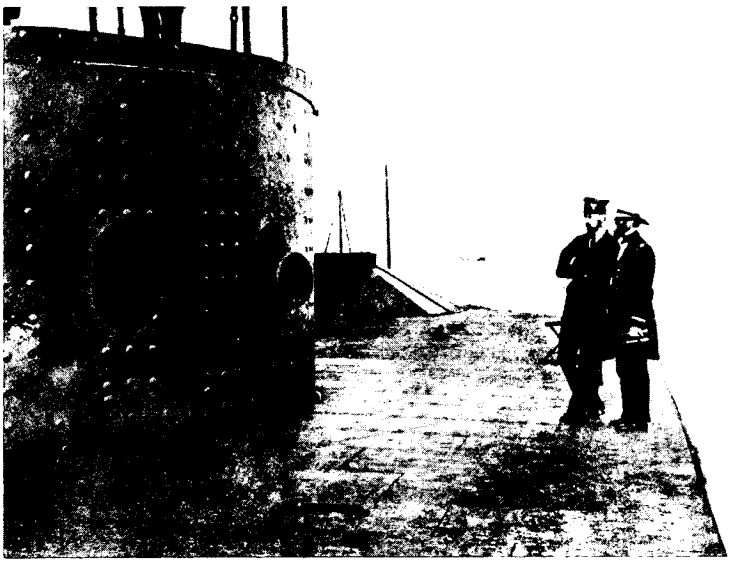
"There is not much left of the *Monitor*. Its once sleek hull is pockmarked by the ravages of the sea: it is a mere skeleton of itself, unrecognizable to all but experts."

(right) The Monitor *in its prime.*



BETTMANN ARCHIVE

met by previous (government-sponsored) expeditions, NOAA spent $1.8 million of taxpayers' money on another photographic expedition; that, while not allowing my support vessel to place a 30-pound anchor near the wreck, in order to facilitate diver access and afford increased safety, NOAA permitted its own expedition to drop four *six-ton* anchors on the site, even though it used no divers and required no safety measures; that, after all the rhetoric aimed at protecting a valuable marine resource, NOAA let its own members fish the wreck.

MNMS had pigeonholed my entire project right from the start, and never had any intention of letting it get a proper review.

I realized the full absurdity of this situation during a recent visit to Halifax. My Nova Scotian friends were dumbfounded to learn that they could take their boat down the coast and dive the *Monitor* at any time. And no one, Coast Guard included, could stop them. Canadians, or the citizens of any other nation, are not bound by U.S. mandates when they are in international waters. The only people prevented from visiting the *Monitor* are U.S. citizens.

There is not much left of the *Monitor*. Its once sleek hull is pockmarked by the ravages of the sea: it is a mere skeleton of itself, unrecognizable to all but experts. The minimum estimate for raising the hulk is upwards of $40 million, not counting the cost of preservation, housing, and eternal maintenance—an unwarranted expense for archaeological provenience considering that, with all the photographs, plans, and written records of the *Monitor*, there is probably nothing further to be learned.

The only thing ironclad about the *Monitor* today is MNMS's stand on no access. Instead of bouncing off cannon balls and solid shot, present arrangements deny access to the very people who are most willing to spend their own money and expend their own efforts to bring to the public the images of their adventures.

The time is long overdue to re-evaluate the entire status of the *Monitor*. Why should Americans be forbidden to dive the wreck? Are there other ways to manage the *Monitor* which would involve less red tape? Why, in fact, should the Federal government maintain ownership and control? Wouldn't a private owner or salvager have strong incentives to put the remains of the *Monitor* to the best possible use?

In a free society, the purpose of the State is not to own or to rule, but to protect the rights and property of its citizens. Abandoned shipwrecks, by the very nature of abandonment, are not the possessions of the government merely by the fact of their existence. If shipwrecks belong to anyone, it is to those individuals with the will and the incentive to dive on them at their own cost and expenditure of time. The confiscation of this property under the guise of "the public good," coupled with the subsequent denial of public access, violates the most basic moral principles. □

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Charles Schwab and the Steel Industry

by Burt Folsom

When asked for the secret of his success in the steel industry, Charles Schwab (1862-1939) always talked about making the most with what you have, using praise, not criticism, giving liberal bonuses for work well done, and "appeal[ing] to the American spirit of conquest in my men, the spirit of doing things better than anyone has ever done them before." He liked to tell this story about how he handled an unproductive steel mill:

> I had a mill manager who was finely educated, thoroughly capable and master of every detail of the business. But he seemed unable to inspire his men to do their best.
>
> "How is it that a man as able as you," I asked him one day, "cannot make this mill turn out what it should?"
>
> "I don't know," he replied. "I have coaxed the men; I have pushed them, I have sworn at them. I have done everything in my power. Yet they will not produce."
>
> It was near the end of the day; in a few minutes the night force would come on duty. I turned to a workman who was standing beside one of the red-mouthed furnaces and asked him for a piece of chalk.
>
> "How many heats has your shift made today?" I queried.
>
> "Six," he replied.
>
> I chalked a big "6" on the floor, and then passed along without another word. When the night shift came in they saw the "6" and asked about it.
>
> "The big boss was in here today," said the day men. "He asked us how many heats we had made, and we told him six. He chalked it down."
>
> The next morning I passed through the same mill. I saw that the "6" had been rubbed out and a big "7" written instead. The night shift had announced itself. That night I went back. The "7" had been erased, and a "10" swaggered in its place. The day force recognized no superiors. Thus a fine competition was started, and it went on until this mill, formerly the poorest producer, was turning out more than any other mill in the plant. (Charles M. Schwab, *Succeeding with What You Have* [New York: Century Co., 1917], pp. 39-41)

Schwab showed the ability to find solutions to problems even as a lad growing up in Loretto, Pennsylvania. According to one of his teachers, "Charlie was a boy who never said, 'I don't know.' He went on the principle of pretend that you know and if you don't, find out mighty quick." Schwab knew early that he would have to live by his wits; his parents and immigrant grandparents weaved and traded wool products, jobs which put food on the table but not much money in the bank. Young Charlie, therefore, started work early in life. In one job he was a "singing cabby": he drove passengers from nearby Cresson to Loretto and entertained them with ballads along the way. One of his passengers, impressed with the gre-

Burt Folsom is Associate Professor of History at Murray State University in Kentucky. This article is adapted from his recent book, Entrepreneurs vs. The State *(available from FEE @ $14.00 postpaid).*

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NEW YORK HISTORICAL SOCIETY

Charles M. Schwab (1862-1939)

garious youth, gave him a travel book. Schwab later said, "It opened my eyes to the glories of the outside world, and stimulated my imagination tremendously." Soon, Loretto, Pennsylvania, population 300, would be too small to contain the ambitious Schwab. With his parents' blessing, he left home at age 17 to clerk in a general store in Braddock, a suburb of Pittsburgh.

Braddock was a steel town, varied in its cultural and urban life. Working in the store, young Charlie often pleased customers with his good looks, wit, and charm; one man whom he impressed was William "Captain Bill" Jones, the mill superintendent at Braddock for Carnegie Steel. Jones offered Schwab a job as a stake driver for the engineering corps who designed plans for building furnaces. Schwab accepted, proved himself capable, and soon became a draftsman. Here, he worked overtime to master his craft; within six months he became Jones' right-hand man at the mill. As Jones' messenger boy, Schwab came into contact with the mill owner, the Scottish immigrant Andrew Carnegie. Carnegie took a special liking to Schwab, who wisely spent some of his off hours playing Scottish ballads on Carnegie's piano.

Schwab worked hard to please Jones and Carnegie. Doing so allowed him to advance in the Carnegie organization. Fortunately for Schwab, Carnegie did not recruit his leaders on the basis of wealth or family standing. He used a merit system; he wanted people who could make the best steel possible at the lowest price. To succeed under Carnegie's system, Schwab would have to master the methods of steel production.

The Carnegie System

Carnegie stressed cutting costs: in fact his motto was "Watch the costs and the profits will take care of themselves." This meant hard work in innovating, accounting, and managing. Purchases, for example, were made in bulk to achieve economies of scale. Also, Carnegie strived for vertical integration, the control of his steel business from the buying of raw materials to the marketing of finished steel.

At the heart of Carnegie's system were bonuses and partnerships for those who excelled. Strong incentives were given employees who could figure out how to save on iron ore, coke, and limestone; or how to produce a harder, cheaper steel; or how to capture new markets for steel. Carnegie explained that success "flows from having interested exceptional men in our service; thus only can we *develop ability* and hold it in our service." In fact, Carnegie said, "Every year should be marked by the promotion of one or more of our young men."

Captain Jones had risen to mill superintendent this way. Among other things he had invented the Jones mixer, a device that cut costs in the transferring of steel from the blast furnace to the Bessemer converter. For his inventions and know-how, Carnegie paid him the highest salary in the business, $25,000—the same salary as that of the President of the United States.

Schwab rose through the ranks just as Jones did. He completed small tasks and was given larger ones. At age 23, he designed and built a bridge over the Baltimore and Ohio Railroad tracks; he saved time and money doing the job and received as a bonus ten $20 gold pieces from Carnegie himself. Other assignments followed: he installed meters in the factories and

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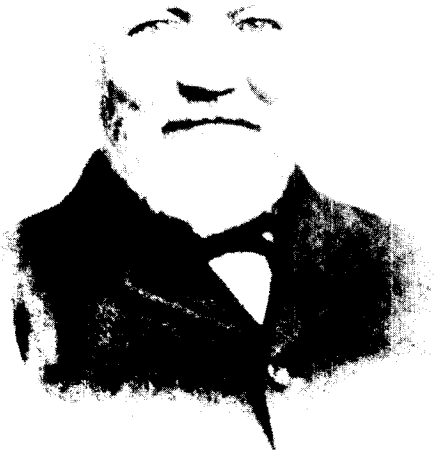

Andrew Carnegie (1835-1919)

reduced waste of natural gas; he redesigned a rail-finishing department and saved 10 cents per ton of steel; he helped in calming down workers during a violent strike in the Homestead plant. When Captain Jones died in a blast furnace explosion in 1889, Schwab was the logical choice for superintendent at Braddock.

Gregarious and competent, Schwab became Carnegie's problem solver. For example, the workers at Braddock were turning out "seconds," or substandard rails. Schwab's solution: give $20 cash bonuses to those steelmakers producing the fewest seconds. The quality of the rails shot up and the resulting increase in profits more than paid the bonuses given. No wonder that Carnegie soon gave Schwab a small partnership in Carnegie Steel, with the promise of more to come if he could keep producing. Carnegie even wrote one of his senior partners, Henry Clay Frick, that Schwab "gives every promise of being the man we have long desired" eventually to run the business.

Schwab idolized Carnegie and found him amazing to watch. Carnegie's efficiency and his thorough knowledge of the industry made him a terror among fellow steel producers. He spied on them, used their annual reports against them, and even wrote them to secure information on costs of production. Meanwhile, Carnegie Steel was a closed corporation; he told outsiders nothing of his costs or his future plans. Carnegie disdained "pools," secret agreements among competitors to divide up the market and keep prices high. Pools were for the weak; Carnegie wanted to "scoop the market [and] run the mills full."

Not that Carnegie didn't use friendships and other means to help him. In bidding on a large Union Pacific contract for rails, he may have outmaneuvered the veteran Scranton family. Joseph Scranton was a director of the Union Pacific as well as president of the Lackawanna Iron and Coal Company. But Carnegie had done a favor for Sidney Dillon, the president of the Union Pacific, and Dillon agreed to give Carnegie the contract if he would match the lowest bid.

Carnegie vs. the Scrantons

In the case of the Scrantons, Carnegie showed no mercy. When Carnegie went into the steel business in 1872, he was told that he could never compete against the Lackawanna Company; Joseph Scranton was a founding father of American rail-making; he had a generation of experience making rails. But that year Joseph Scranton died, and his sons William and Walter would be the ones to challenge Carnegie: first with the Lackawanna Company, then with their Scranton Steel Company. Carnegie and the Scrantons joined the Bessemer Steel Association in 1875, but their approaches were different: the Scrantons wanted a pool, but Carnegie told them and others that unless he got the largest share he would "withdraw from it and undersell you all in the market—and make good money doing it."

The Scrantons and the others were bluffed by Carnegie and gave him his way. Carnegie then studied the Scrantons and learned their strengths and weaknesses. He discovered that they (and others) were discarding the thin steel shavings, called "scale," that fell on the floor when the steel passed through the rollers. When he learned this, he regularly sent a man to Scranton to cart away tons of the Scrantons' scale, almost free of charge, and brought it to

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Pittsburgh to use in making rails for Carnegie Steel.

As Carnegie moved to the top of the American steel business, Schwab watched, learned, and proved himself time and again. In 1897, the 35-year-old Schwab became president of Carnegie Steel and the two men ran the company together. Business was never better. Schwab put in 16 new furnaces at the Homestead plant, and costs per ton of finished steel fell 34 per cent in one year. To promote espirit de corps, Schwab held Saturday meetings with all of his superintendents to work out problems. Meanwhile, the results of large-scale production took hold: the cost of making rails fell from $28 to $11.50 per ton between 1880 and 1900, but the profits from the larger volume of business went from $2 million in 1888 to $4 million in 1894, to $40 million in 1900. Some people wondered if Carnegie Steel might soon capture the steel trade of the entire world.

Such speculating was premature. The next year, at age 65, Carnegie retired and, with Schwab as his emissary, sold Carnegie Steel to J. P. Morgan for $480 million. Morgan then combined Carnegie Steel with other companies to create U.S. Steel, the first billion-dollar company in American history. The choice for president of the company: Charles Schwab.

Reporters and critics condemned "The Steel Trust," as they called U.S. Steel, for its size and its potential to monopolize. Who would be able to compete, they asked, with such a large vertically integrated company? At his disposal, Schwab would have 213 steel mills and transportation companies, 41 iron ore mines, and 57,000 acres of coal land—enough, critics charged, to dwarf competitors and keep prices high.

Schwab discovered, however, that he would not be able to use the Carnegie system at U.S. Steel. In fact, he would not have authority to run the company at all. Morgan and his friend Elbert Gary had organized U.S. Steel so that an executive committee, headed by Gary, and the board of directors would set the policies of the company; Schwab, as president, would carry them out. Morgan and Gary were interested in business stability, not in innovating or in cutting the price of steel. For example, when Schwab wanted to secure more ore land, Gary said no. He also opposed price-cutting, aggressive marketing, giving bonuses, and adopting new technology. Schwab later said, "Gary, who had no real knowledge of the steel business, forever opposed me on some of the methods and principles that I had seen worked out with Carnegie—methods that had made the Carnegie Company the most successful in the world."

Elbert Henry Gary
(1846-1927)

Gary, Indiana, a U.S. Steel "town," was named for him.

Personal Problems

Schwab's personal life, more than disputes over policy, seems to have led to his downfall at U.S. Steel. He showed he had the values of a dissipater as well as those of an entrepreneur. When Carnegie was in control, Schwab consciously restrained his extravagant tastes; Carnegie deplored living beyond one's income, gambling, and adultery. But out from under Carnegie's grip, Schwab engaged in all three and almost ruined his marriage and his career. In New York City, Schwab built "Riverside," a gargantuan mansion, which consumed one whole block of the city and $7 million of his cash. He also gambled at Monte Carlo, which

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made bad newspaper copy and cost him credibility. Finally, he had an affair with a nurse, which resulted in a child. Though Schwab hid this from the press, he could not do so from his wife, Rana. The strain of his adulterous behavior, combined with the pressure of Monte Carlo, the expense of Riverside, and the barbs from Elbert Gary wrecked Schwab's health. He went to Europe to recover and, in 1904, resigned as president of U.S. Steel.

Schwab, the man who said, "I cannot fail," seemed to have failed. He was depressed for months. Even Carnegie repudiated Schwab and this added to the pain. During his troubles he had insomnia, he lost weight, his arms and legs were regularly numb, and sometimes he fainted. His wife forgave him for his adultery and this no doubt eased the strain; but she was still not happy because she wanted a child of her own and never had one. She didn't covet the extravagant life, so dear to her husband, and she spent many lonely days at Riverside.

Schwab was out at U.S. Steel, but he already had the makings for a comeback. When he was president of U.S. Steel, Schwab had bought Bethlehem Steel as a private investment. He was criticized for this, especially when he merged Bethlehem Steel with some unsound companies into an unprofitable shipbuilding trust. This merger eventually collapsed; but when Schwab stepped down at U.S. Steel, he still had Bethlehem Steel as his own property. The demotion from being president of a company worth over one billion dollars, to being president of one worth less than nine million dollars would have embarrassed some men, but not Schwab. He would have full control in running the company and would succeed or fail on his own abilities.

Before Schwab took over Bethlehem Steel, its future had not looked promising. It had been founded in 1857 and soon produced rails for the Lehigh Valley Railroad. This was more than coincidence because entrepreneur Asa Packer, who had built the Lehigh Valley Railroad, held a large interest in what was then Bethlehem Iron. Packer, a Connecticut Yankee, had the vision and ability to promote both of these investments and make them profitable. His rise from carpenter to railroad tycoon had made him a legend in Pennsylvania; he was worth $17 million by the late 1870s. When he died in 1879, his sons, sons-in-law, and nephews took over his investments, but did not have the success that Packer did. The Lehigh Valley Railroad floundered and went into receivership in the Panic of 1893. Bethlehem Iron almost shared the same fate.

Led by Philadelphians and the Packer group, Bethlehem Iron became very conservative after Packer's death. The younger leaders single-mindedly produced rails, even though Carnegie was doing it cheaper, and they had the expense of importing most of their iron ore from Cuba. They escaped a price squeeze in 1885 when, reluctantly, they shifted from making rails to producing military ordnance, which commanded a higher price per ton than rails. Such an imaginative strategy, as one might expect, did not originate within the Packer group; in fact, they resisted it until declining profits on rails presented them with no alternative.

From Rails to Armor Plate

The wise, if belated, switch from rails to gun-forgings and armor plate led to profits because Bethlehem Iron was the only bidder on its first government contract for ordnance in 1887. Other contracts were forthcoming and Bethlehem Iron "established a reputation for quality and reliability," if not for aggressiveness and efficiency. Regarding the last, its operations were so inefficient that the company in 1898 hired Frederick W. Taylor, master of scientific management, to suggest ways of improving worker productivity. Yet the Packer group soon became hostile to Taylor's cost-cutting ideas. Of one suggestion to reduce the number of workers handling raw materials, Taylor observed that the owners "did not wish me, as they said, to depopulate South Bethlehem." He further commented, "They owned all the houses in South Bethlehem and the company stores and when they saw we [Taylor and his assistants] were cutting the labor force down to about one-fourth, they did not want it." They also rejected Taylor's suggestions to standardize job functions and give raises to key personnel.

Surviving, then, on government contracts, Bethlehem Iron stumbled into the twentieth

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century—a profitable operation in spite of itself. In the midst of this conservatism, Schwab came to Bethlehem in 1904 and boldly announced that he would "make the Bethlehem plant the greatest armor plate and gun factory in the world." Taking the helm, Schwab "backed Bethlehem with every dollar I could borrow." This backing included buying new branch plants and closing unprofitable ones, getting new contracts by selling aggressively, and reorganizing the company as Bethlehem Steel. Planning for the future, Schwab bought large tracts of land for the company east of South Bethlehem. He also bought or leased more ore land and mechanized the company's Cuban iron fields to spur production there.

Schwab's entrepreneurship clashed with the Packer group's cautiousness right from the start. As one historian said, "Many of the veteran Bethlehem executives preferred the old, pre-Taylor and pre-Schwab way." Soon after arriving in South Bethlehem, Schwab ousted the inbred Packer group from authority. In the new president's remarkable words, "I selected 15 young men right out of the mill and made them my partners." Two of these "partners" were Eugene Grace, the son of a sea captain, and Archibald Johnston, a local Moravian. They later became presidents of Bethlehem Steel.

After reorganization, Schwab wanted to diversify his company and challenge U.S. Steel. To do this, he began making rails and moving Bethlehem Steel away from its dependence on government contracts. Schwab adopted open-hearth technology because it produced better rails than the Bessemer system did. As historian Robert Hessen notes:

> U.S. Steel, the nation's largest rail producer, did not follow Schwab's lead; it would have had to replace its Bessemer facilities with open hearth equipment. Being a late starter, Bethlehem enjoyed a clear advantage: with no heavy investment in obsolete equipment to protect, it could adopt the newest and most efficient technological processes. (*Steel Titan: The Life of Charles M. Schwab* [Oxford University Press, 1975], p. 169).

Schwab's reorganization of the Cuban ore mines also improved Bethlehem's competitive position at the expense of U.S. Steel.

> Cuban ore was richer in iron and lower in phosphorus than was the Mesabi range ore used by U.S. Steel. It also had another advantage: it contained large amounts of nickel, so that Bethlehem could produce nickel steel at no extra cost. For a ton of iron Bethlehem's cost was $4.31; U.S. Steel's was $7.10. (*Steel Titan: The Life of Charles M. Schwab,* p. 171)

Now that Schwab was running an efficient, diversified company he turned his attention to cutting costs. He reasoned that employees would work harder if they knew it would result directly in a raise. Therefore, he set up a bonus system for productive laborers, foremen, and managers throughout the company. As Schwab described it, "Do so much and you get so much; do more and you get more—that is the essence of the system." At U.S. Steel, by contrast, Gary tied bonuses to the overall profitability of the company, not to individual performance. Under that system, Schwab noted, a worker could toil hard and creatively, but receive no reward.

Improvements in Structural Steel

Schwab's biggest move at Bethlehem was his challenge to U.S. Steel in the making of structural steel. Here he focused on an innovation in making the steel beams that went into bridges and skyscrapers. Schwab had been listening to Edward Grey, who had the idea of making steel beams directly from an ingot, as a single section, instead of riveting smaller beams together. Grey claimed that his invention provided "the greatest possible strength with the least dead weight and at the lowest cost."

The other steelmakers rejected Grey's theory; but Schwab was eager to try it even though it would cost $5 million to design the plant, build the mill, and pay Grey's royalties. The problem was that the experts were so skeptical that Schwab had trouble raising money. In fact he almost backed out, but then jumped back in with the statement: "If we are going bust, we will go bust big." He staked his own money, and that of his company, on the Grey

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beam, but still he needed more. So Schwab buttonholed wealthy investors for large personal loans and then, through remarkable salesmanship, persuaded his major suppliers, the Lehigh Valley and the Reading Railroads, to give him credit on deliveries of the new steel. Schwab then aggressively recruited big contracts for the "Bethlehem beam": the Chase National Bank and the Metropolitan Life Insurance Company in New York were among them. The experiment worked. This cheaper and more durable beam quickly became Schwab's greatest innovation and he captured a large share of the structural steel market from U.S. Steel.

Schwab's actions had consequences for the American steel industry. From 1905 to 1920, Bethlehem Steel's labor force doubled every five years. By contrast, U.S. Steel often stagnated; one officer noted after Schwab left that "works standing idle have deteriorated . . . the men are disheartened and a certain amount of apathy exists." By the 1920s, the chagrined leaders at U.S. Steel secretly began making Bethlehem beams; as an official there observed, "The tonnage lost on account of competition with Bethlehem . . . is . . . ever increasing . . . we are obliged to sell at unusually low prices in order to compete." Schwab discovered their ploy, however, and forced U.S. Steel to pay him royalties.

Schwab had transformed Bethlehem Steel. Even before World War I his company had become the second largest steelmaker in America. The *New York Times* praised Bethlehem Steel as "possibly the most efficient, profitable self-contained steel plant in the country." By 1920, it employed 20,000 people in the Lehigh Valley and was among the largest enterprises in the world. In 1922, it absorbed Lackawanna Steel, the company that launched America's rail-making industry 75 years earlier.

During World War I, Schwab's abilities were needed by the U.S. government. In April 1918, one year after America entered the war, victory was uncertain. Delays in shipping cargo and troops from America to Europe threatened the Allies with defeat. More ships were needed; but in the U.S. shipyards few ships were forthcoming. Within the Wilson administration some blamed the owners of the shipyards, others blamed the workers, still others blamed radical unions. In the midst of this finger-pointing, Franklin K. Lane, the Secretary of Commerce, posed a solution: "The President ought to send for Schwab and hand him a treasury warrant for a billion dollars and set him to work building ships, with no government inspectors or supervisors or accountants or auditors or other red tape to bother him. Let the President just put it up to Schwab's patriotism and put Schwab on his honor. Nothing more is needed. Schwab will do the job."

The Schwab Formula

That month Schwab became Director-General of the Emergency Fleet Corporation for the U.S. government. In his investigation, he discovered cases of laziness, incompetence, work slowdowns, and poor coordination of the ship building. As usual, though, Schwab said, "The best place to succeed is where you are with what you have." He quickly rearranged incentives: he eliminated the "cost-plus" system whereby shipyards were paid whatever it cost them to build ships plus a percentage of that as a profit. Instead, Schwab tied profits to cost-cutting by paying a set price per ship. Cost overruns would be paid by the shipbuilders who would have to be efficient to make a profit. As usual, bonuses were part of the Schwab formula. He paid them, sometimes out of his own pocket, to shipbuilders who exceeded production goals.

Schwab enjoyed being a showman, so he went to the shipyards himself: he rallied the workers, praised the owners, and even drew applause in a speech to the Industrial Workers of the World, a radical union. Never one to ignore symbols for achievement, Schwab had Rear Admiral F. F. Fletcher head a group to award flags and medals to plants and workers whose work had been outstanding. By the fall of 1918, ships were being completed on time and even ahead of schedule. President Wilson and the leaders of the Shipping Board were astonished with the change and gave Schwab the credit. Carnegie, in the last year of his life, called it "a record of accomplishment such as has never been equaled."

Not all of Schwab's dealings with the federal government were so productive. The armor-

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plate business is an example of this. The making of military equipment—armor plate for ships, gun forgings, ordnance, and shrapnel—brought Schwab into regular contact with government purchasers. Throughout his career, Schwab had problems with these government contracts. Even at Carnegie Steel, Schwab had quarreled with government officials over allegedly defective armor plate; the issue never was amicably settled.

The problem began in the 1880s when various officials began urging the United States to build a large navy. At the time the American steel companies were mostly making rails, so President Cleveland and others began urging the companies to diversify. Making military equipment was complicated and expensive, however; only reluctantly did Bethlehem Iron and Carnegie Steel shift into ordnance. Had the government not promised them Navy contracts they would not have switched.

Four things in the military supply business made for tension between the federal government and the steel companies. First, the federal government was the largest and sometimes the only buyer of military equipment; and the government's notions of quality sometimes differed from that of the producers. Often both sides had legitimate points of view. Second, since the demand for military equipment was limited and the costs of building a factory to produce it were high, only U.S. Steel, Bethlehem Steel, and later Midvale Steel made armor plate. The potential for either a monopoly or for price-rigging bothered some government officials. Third, a ton of military equipment was more expensive to make than a ton of rails or a ton of structural steel; some purchasers thought that $450 for a ton of armor plate was price-gouging if rails sold for only $25 per ton. Finally, the ordnance producers sometimes made lower bids on foreign contracts than they did on domestic ones. To some in the American government, this was evidence they were being overcharged; to the steel companies, lower bids meant they had to cut their profit margins to almost zero to overcome tariffs in foreign countries. Also, when American needs were low, the steel men argued they had to get foreign business to keep their factories operating.

The government's solution to these four problems was to threaten to go into the military supply business and build an armor-plate factory with Federal funds. Schwab countered that the government would not be able to make armor plate cheaper than he could. After all, Bethlehem had a veteran work force, a good bonus system, and could buy materials more cheaply in bulk. Any vertically integrated company would have an advantage over companies purchasing supplies in the open market. A government factory, Schwab insisted, would waste the taxpayers' money.

Misdirected Incentives

If Schwab had been a mediator, not a participant, he might have been able to settle this dispute. Part of the problem was the same as that of the low productivity of the American shipyards during World War I: misdirected incentives. When the navy took bids for contracts from the three steel companies, it naturally accepted the lowest bid. But then Navy officials went to the two higher bidders and offered them part of the contract if they would agree to accept the lowest bid. They did this so that all three producers could survive; that way, a future monopoly of ordnance would be prevented. The problem was that this strategy gave the three companies an incentive to collude and fix prices high. Why should they bid low if all of them would get part of the contract anyway? A winner-take-all approach would have provided an incentive for lower bidding, but the Navy was unwilling to do this. Not surprisingly, then, year after year the steel companies submitted nearly identical bids for military equipment.

This problem reached a crisis during the Wilson administration. In 1913, Josephus Daniels, Wilson's Secretary of the Navy, and Ben Tillman, Senator from South Carolina, investigated the armor business. Both men urged Wilson to back a government armor plant. They held hearings in Congress on the armor business but did not like what they heard. The leaders of the three steel companies all said their bids were reasonable. In fact, Schwab submitted figures showing that he and the others charged less for armor plate than did Eng-

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land, France, Germany, and Japan. If others didn't believe it, then let the Federal Trade Commission look at the accounts and fix a price. Daniels and Tillman rejected this. They were convinced that the government could make armor plate cheaper: the head of the Bureau of Ordnance estimated that $10.3 million would build an armor plant and that plate could be made for less than $300 per ton, instead of $454 per ton, which was a typical bid from the steel companies.

In 1916, then, Daniels and Tillman began the campaign to convince Congress to spend $11 million for an armor factory. In the Senate, Tillman argued that the government would save money and no longer would be at the mercy of identical bids from the "greedy and hoggish" steel companies. President Wilson backed Tillman and said, "I remember very well my promise to help all I could with the bill for the construction of an armor plant and I stand ready to redeem my promise."

Schwab led the effort to defeat the bill. He spoke out against it in public and ran ads in over 3,000 newspapers challenging the need for a government plant. He stressed the fairness angle. He said that years ago the government had asked Bethlehem to make armor; they had done so only when the government agreed to buy from them. Now, with $7 million invested in equipment, the government was planning to build its own plant and make Bethlehem's useless.

Most Congressmen, however, bought the arguments of Tillman and Daniels. The bill passed the Senate and the House by about two-to-one margins, and Wilson signed it. As Senator Albert Cummins of Iowa said, "It is [one of] my profoundest convictions that the manufacture of armor-plate for battleships is a government function. I hope the private enterprises will be entirely eliminated."

Dozens of cities lobbied to be the site for the new plant. From Rome, Georgia, to Kalamazoo, Michigan, city after city was put forth as being uniquely situated to produce armor plate. The winner of this competition was South Charleston, West Virginia. Congress soon raised the appropriation to $17.5 million and authorized the South Charleston plant to make guns and projectiles, as well as armor. Construction began in 1917 on the new factory and on hundreds of houses for the workers. The war delayed the building, but it was continued later. Higher construction costs after the war meant an overrun of several million dollars. By 1921, the new plant was making guns, projectiles, and armor—all at prices apparently much higher than that of Bethlehem Steel. Within a year the whole plant was shut down, put on "inoperative status," and never run again.

Looking Backward

Schwab turned 60 in 1921 and was beginning to look backward more than forward. There was much to see: whether he had made rails, beams, or armor plate, he had been successful. Even Carnegie, near death, had written Schwab, "I have never doubted your ability to triumph in anything you undertook. I cannot help feeling proud of you for having far outstripped any of my 'boys.' "

In the 1920s and 1930s, however, Schwab seemed to lose his entrepreneurial spirit. Producing a better product at a lower price no longer seemed to dominate his thinking. Let's "live and let live" Schwab told the steelmakers at the American Iron and Steel Institute in 1927. Next year, he urged them to fix prices and avoid cutting them. The year after this, Schwab, the father of the Bethlehem beam, urged the steel men not to expand but to use their existing plant capacity.

When the Great Depression took hold in the 1930s, Schwab's public addresses were full of anecdotes and preaching that "the good . . . lies ahead." One of Schwab's remedies for the ailing economy was a high protective tariff. He had always favored a tariff on imported steel but usually settled for low duties. The Smoot-Hawley Tariff of 1930 created the highest duties in American history on many items. Some writers have argued that the Smoot-Hawley Tariff triggered the Great Depression; others say it merely made the depression worse. One thing is certain: many nations retaliated against high American tariffs by closing their borders to American-made goods. The demand for American goods, therefore, declined and this put more people out of work. When Cordell Hull, Roosevelt's Secretary of State,

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tried to lower American tariffs in 1934, Schwab opposed it. He was afraid of foreign competition.

During the 1930s, Schwab enjoyed his role as elder statesman of the steel industry. He was full of stories and ever ready to do interviews with reporters. He never became senile; his ability to memorize speeches and his knack for remembering names and faces was still amazing. He just preferred to let Eugene Grace and others run Bethlehem Steel, while he worked the crowd.

When Schwab retired as an entrepreneur, his fortune became jeopardized. He had earlier shown the traits of a dissipater and still had the potential to run through his $25 million fortune. Liberated from work, Schwab traveled, gambled, and flirted more than ever. He joined the New York Whist Club and played there for high stakes. He frequented the roulette tables in Monte Carlo with his favorite mistress. The art of speculation, an anathema to Carnegie, appealed to Schwab: he installed a ticker tape in his mansion to keep tabs on Wall Street; he also invested in a variety of companies and knew almost nothing about some of them. Gambling wasn't the only drain on Schwab's wealth: he co-signed one million dollars worth of notes—usually worthless—for "friends" and also gave monthly allowances to 27 people.

Schwab refused to cut back on expenses, even during the Great Depression. He still hired the most famous musicians of the era to give private recitals for him at Riverside. The mansion itself—complete with swimming pool, wine cellar, gymnasium, bowling alley, six elevators, and 90 bedrooms—needed 20 servants to keep it functioning. He also hired 300 men to care for his 1000-acre estate at Loretto. So Schwab desperately needed his $250,000 annual salary from Bethlehem, given for past services, just to pay his expenses.

From 1935 to 1938, a small group of rebel stockholders attended the company's annual meetings; they challenged Schwab's salary and told him he had "outlived his usefulness." He finally stopped them by privately telling one of the critics that he desperately needed the money to live on. Actually he needed more. He couldn't pay the taxes on Riverside and couldn't sell it either, even at a $6 million loss. He couldn't even give it away, when he offered it as the residence for the mayor.

Schwab's last years were also marked by poor health and the death of his wife. After her funeral, Riverside was taken by creditors; Schwab moved into a small apartment. Schwab, who had shown the world a vision of entrepreneurship, now had only a vision of death. "A man knows when he doesn't want to be alive," he said, "when the will to continue living has gone from him." Schwab died nine months after he said this, at age 77, with debts exceeding assets by over $300,000. □

For full footnote citations on quoted materials and other sources, see *Entrepreneurs vs. The State*. Readers are especially directed to Robert Hessen's excellent study, *Steel Titan: The Life of Charles M. Schwab* (New York: Oxford University Press, 1975).

Self-Service

IDEAS ON LIBERTY

If it be selfishness to work on the job one likes, because one likes it and for no other end, let us accept the odium. I had rather live forever in a company of Don Quixotes, than among a set of angels professing to be solely moved to the betterment of one another. A community of creatures engaged primarily in serving one another, except for the joy of meddling in one another's business, appears, to me at least, so dreary and so empty, that I would have no part or parcel in their pallid enterprises.

—JUSTICE LEARNED HAND
The Spirit of Liberty

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What Should We Do About Luck?

by James L. Payne

What should we do about the fact that some people are able to earn more money than others? Should government redress the resulting disparities in income? The answer is often believed to hinge upon our conclusion about the role of luck in affecting income-earning abilities.

Those on the political left emphasize factors beyond the individual's control. They point to accidental circumstances affecting incomes: where you were born, who your parents are, your class, or race, or culture, the education you receive, the economic possibilities in your society.

Accepting the view that the ability to earn income is largely a matter of luck, the left supports programs of income redistribution to compensate for these differences. Wealth is to be taken from the (lucky) wealthy and given to the (unlucky) poor. In this way, they say, we are correcting for inequities of nature and culture and producing a "fair" result.

Those on the right have tended to object to this policy on the ground that it really isn't luck that makes the difference. Often citing themselves as examples, they point out that wealth is the result of hard work and self-sacrifice. People are poor, they say, not because they had bad breaks but because they are lazy.

This view is a popular one in an American culture that extolls the "self-made millionaire," the Horatio Alger boy who lifts himself "by his own bootstraps." In this tradition we

applaud W. E. Henley's famous stanza (from "Invictus"):

> It matters not how strait the gate,
> How charged with punishments the scroll,
> I am the master of my fate:
> I am the captain of my soul.

Who is right? What should we do about luck?

In overall, cosmic terms, it seems difficult to refute the left's position. All that we are, each molecule within us, comes from beyond ourselves. If one prefers the religious formulation, we must ultimately trace our abilities and successes to the endowments of an omnipotent God. One can even argue that willpower itself is part of the biological makeup: some people just have a higher energy level or more determination than others.

On social grounds as well, those emphasizing the importance of luck would seem to have the sounder position. The arrogance of the "self-made man" is corrosive. His bragging about his "own" success provokes resentment, and his conviction that the poor are to blame for their plight makes him uncharitable. It is much nicer to live in a society where people accept

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the traditional Christian orientation, that God gives us everything, "ourselves, our time, and our possessions"—as it is put in the *Lutheran Book of Worship*. Believing this, people are more disposed to help their neighbors in times of trouble.

It is healthy, therefore, to acknowledge the enormous role played by luck in personal success. But it does not follow that this perspective should be the foundation of government policy. This is where the left goes wrong.

The first problem with using the state to redress the effects of luck is ethical: it is not moral to use force against someone in retaliation for his good fortune. The point is easily overlooked because we often forget that government action is grounded upon coercion. It is further obscured because taxation generally involves policy aims in addition to income redistribution.

To see the point clearly, let us imagine the operation of a pure system of redistributive taxation. Government agents say that John must pay, let us say, $5000 *because* he earned an above-average income. John disagrees and resists, the agents bring force to bear, and John winds up being fined or thrown in jail. Hence John has been *punished* for an action—earning more money than another—which should not be considered a crime. In fact, his behavior is commendable, for the work he has done to earn his high income is socially useful.

We can still maintain that John has a responsibility toward those less fortunate than himself, but we should advance this position through persuasion, seeking its implementation through voluntary means, not state coercion.

The second objection to state redistribution of wealth to correct for the effects of luck is economic. Individuals may not be responsible for their talents and abilities, but they are *motivated* beings. They respond to the rewards and penalties which confront them. It is in this sense that a rich person might feel "self-made." He knows that his wealth came as the result of hard work and sacrifice, not by sitting under a tree. When we pursue a particular payoff and achieve it, we feel proud of our effort. We feel that the reward—a pay check, let us say—did not come through some kind of "accident" or "luck." We know that we worked!

Because we are motivated organisms, policy-makers have to be careful how they manipulate the pattern of rewards. Unfortunately, left-wingers are rather insensitive to this issue. They tend to assume that people will go on doing good and constructive things in spite of governmental policies that weaken the relevant incentives. Working, in particular, is thought to be automatic: teachers will teach and welders will weld regardless what we do to the incentive systems which support these activities.

But of course this view is naive. Work and productivity in work are extremely sensitive to reward systems. This is why state redistribution policies are so harmful: they undermine incentives for both the lucky and the unlucky. The more productive members of society are discouraged from being as productive as they could be by denying them some of the fruits of their labor, as is clearly done in an income tax. And the less productive are discouraged from working since they are supported by unworked-for income.

Voluntary charity as a method to compensate for luck largely avoids the drawbacks of state systems. For the donors, voluntary charity does not discourage work but becomes a reason *to* work. Charitable giving is a consumption item that the donor freely spends his money on, like buying a stereo or tickets to the opera.

For the recipients, the main problem with state charity is its routine, perpetual character. This feature seems inevitable when government is involved, since the distribution of money must be tied to firmly established regulations in order to be (or seem) fair and accountable to the entire nation. The regularity of state monies maximizes their disincentive effect: the recipients can become dependent upon them.

Private charity, especially individual charity, is much more flexible and, from the recipient's point of view, undependable. It can thus be the "helping hand" in an emergency without becoming a permanent part of the beneficiary's work and income calculations.

The Biblical injunction to accept ourselves humbly as creatures of God, not as self-made men, is healthy. And so is the exhortation to help those less fortunate than ourselves. The error lies in using the state in an attempt to implement these ideas. □

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Origins of the Chinese Hyperinflation

by Jay Habegger

Between 1935 and 1949, China experienced a hyperinflation in which prices rose by more than a thousandfold.[1] The immediate cause of the inflation is easy to isolate: the Nationalist government continually injected large amounts of paper currency into the Chinese economy. The monetary expansion was so severe that during World War II, Nationalist printing presses were unable to keep up, and Chinese currency printed in England had to be flown in over the Himalayas.[2]

A prerequisite for any sustained inflation, however, is monopoly control of the money supply. In the absence of a monopoly, individuals simply will switch to a competing currency when one becomes inflated. Thus, a key question in the study of any inflation is how the state obtained monopoly control.

In the case of the Chinese inflation, this question has been largely overlooked. Most authors who have chronicled the inflation have focused on events which occurred after the Nationalists managed to obtain control of the currency. Let us thus examine how the Nationalist government gained monopoly power over the Chinese currency.

Prior to 1935, China enjoyed a limited free banking system. Privately owned banks operated thoughout China, although the largest Chinese banks and all the foreign-owned banks were based in Shanghai. Some provincial governments controlled their own banks, but they had to maintain the same standards as private banks in order to compete.

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Privately held banks operated like any other Chinese business and competed with one another to obtain customers. Most banks issued their own notes which were redeemable in silver, the traditional medium of exchange in China. The notes from each bank circulated freely with the notes from other banks. Perhaps most noteworthy is that Chinese banks operated largely without state regulation. A free banking system has inherent checks against inflation—primarily because customers will flee from depreciating currencies—and instances of banks' inflating their currencies were extremely rare.[3]

The arrival of the Nationalist government in 1927 started a long process to eliminate free banking in China. By 1935, the Nationalists had succeeded. Rather than outright seizure, they followed an incremental approach to gain control of the currency. The first steps were aimed at insuring the political and financial support of the largest Chinese banks. Eventually, the banks would become dependent on the government. The final step was to bring Chinese banks under direct control of the Nationalists, removing all barriers to currency control.

In 1927, the process began when banks got caught in the political split between the Nationalists and the Communists. Violent strikes led by Communist labor leaders crippled industry in Shanghai. When the bankers appealed to the Nationalist Party to stop the strikes, Chiang Kai-shek saw an opportunity to bolster the financial position of his new government. He struck a deal with the bankers which stipulated that Chiang would suppress the strikes, in return for loans to the Nationalist government.

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Believing that a Nationalist victory would be more favorable to their businesses than a Communist success, and anxious to protect their loans to the Nationalists, the banks became a quick source of funds for the Nationalist government, as well as staunch supporters, even while their freedom to operate was being eroded.

Eventually the bankers became leery of lending more funds to the Nationalists. The government appeared to be a financial black hole, and the bankers were skeptical of its ability to service its debts. When the bankers refused to extend more loans to the Nationalists, Chiang used the same methods against the bankers that he had used against the strikers. A banker who wouldn't supply more loans might be thrown in jail as a political subversive or have his property confiscated.

Reliance on Deficit Financing

The reason the Nationalists needed bank loans was their heavy reliance on deficit financing. Widespread taxation was politically unattractive as well as an administrative nightmare. Under these circumstances, Chiang saw deficit spending as the most expedient method to finance his government. For example, in 1927, the first year of the Nationalist regime, loans accounted for 49 per cent of government revenue.[4] And the government continued to increase its debt without any way of servicing it.

To prevent the bankers from becoming politically disaffected and to maintain long-term financial support, Chiang's Finance Minister and brother-in-law, T. V. Soong, promoted a policy of "cooperation" with the bankers. Soong's aim was to further tie the bankers to the fate of the Nationalist government.

In the spring of 1928, Soong began to put his plan into action. He arranged for the Nationalist government to offer large quantities of securities. To insure purchase, the securities carried high interest rates and were sold at substantial discounts from their face values. For example, the government sold securities in 1931 at little more than 50 per cent of their face values.[5] Thus, the Nationalists postponed their financial problems until the bonds came due.

The bankers were aware of the potential problems with the bonds, so to make them even more salable, the securities were guaranteed. Each issue was backed by a government revenue, such as customs taxes or salt taxes. Because of the incentives, the rate of return on government securities was far greater than anything the bankers could have obtained on similar investments in private concerns.

Soong also set out to develop a system of public finance patterned after Western nations. In 1928 he founded a central bank, the "State Bank of the Republic of China," although he hadn't as yet been able to establish a government monopoly over the issuance of notes.[6]

At the outset the bank was primarily an extension of the Nationalist Treasury, although it did issue its own notes. While the Central Bank primarily handled the revenue of the Nationalist government, it also competed with private banks for business. The revenues of the bank were used to purchase government bonds. To enhance the bank's image and further tie other private banks to the Nationalist government, Soong appointed many of the directors of private banks to the board of directors of the Central Bank, although the board actually held little power.

The market for government bonds was supported by the Chinese banks. By 1932, Chinese banks located in Shanghai held between 50 per cent and 80 per cent of outstanding government bonds.[7] As intended, the banks were financially bound to the Nationalist government. Government activities had a large effect on the values of banks' assets, so that the relationship between the Nationalists and the banks grew even closer. Commonly, Nationalist officials who controlled the issuance of government bonds would sit on the boards of private banks. Having inside information, many government officials became extremely wealthy trading in government securities.[8]

The financial events following the Japanese invasion of the Chinese mainland in January 1932 illustrate just how closely the banks were tied to the Nationalist government. When the Japanese force landed, a panic spread through the bond market and a rush developed to unload government securities. Within five days of the invasion the average price of government bonds

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dropped to less than 60 per cent of face value, which represented a severe loss for banks holding a large amount of bonds.[9] Fearing that the notes of some banks soon would become *irredeemable*, *panic spread and there were* "runs" on some banks; at least two Chinese banks failed due to the crisis.[10]

While the Nationalists tried to end the autonomy of the banks by binding them to the government, the final blow to Chinese private banking came from the United States. Beginning in 1933, the U.S. began to purchase large amounts of silver, and in June 1934 the Silver Purchase Act was passed. This Act instructed the United States Treasury to purchase silver until the world price of silver rose above $1.29 per ounce, or until the monetary value of the U.S. silver stock reached one-third the monetary value of the gold stock.[11]

Although the Silver Purchase Act was intended primarily as a commodity support program for silver producers in the United States, it had an enormous effect in China. As a result of the U.S. legislation, the world price of silver jumped rapidly, and from early 1933 to the end of the year the price of silver rose by 75 per cent; by the middle of 1935 the price had tripled.[12] Since almost every bank note in China was backed largely by silver, the U.S. silver buying program triggered a sharp deflation in China. The appreciated silver caused exports to shrink while imports rose, which produced a net outflow of silver. The banks sold their silver abroad, withdrew notes from circulation, and slowed the rate of new note issue.

The declining supply of bank notes caused each note left in circulation to appreciate in value, leading many businesses to experience accounting losses. With prices falling, selling prices often could not meet the previous costs of inputs. The losses caused many businesses to lay off workers and cut production.

Also, many businesses carried some debt. The loans were made in non-deflated currency, but now had to be paid back in deflated money. The real value of the debt ballooned while the businesses had less cash flow to service it. Unable to foresee the actions of the U.S. Congress, businessmen had assumed debt which appeared to be a prudent risk. Now they had more debt than they had bargained for. Of course, the Nationalists also were feeling the adverse effects of the deflation. Their policy of debt financing suddenly became an even greater burden.

BETTMANN ARCHIVE

Chiang Kai-shek at time of attempt to organize war against Japan, c.1936.

In an effort to stop the deflation, the Nationalist government imposed export controls on silver. The export controls proved unsuccessful, and the smuggling of silver became an occupation in itself. Much silver was smuggled through foreign-owned banks, since they were immune from Chinese regulations.

The desperate financial situation wrought by the deflation prompted the Nationalist government to seek new revenue sources. It granted the Central Bank special privileges, such as exemption from silver export controls, so that the Central Bank was able to earn large revenues while private banks were struggling. Because of government patronage, the Central Bank became the most profitable financial institution in China. Although it held only 11 per cent of the assets of all Chinese-owned banks, it earned 37 per cent of all banking profits in 1934.[13] Most

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of the Central Bank's profits were used to finance the Nationalist regime.

Despite export controls and the revenues of the Central Bank, throughout 1934 the financial situation of the Nationalist government became increasingly worse. In an attempt to sell more government securities, the Nationalists issued the Savings Bank Law. This legislation required each savings bank to purchase government bonds until its holdings of such bonds represented one-fourth of total deposits. But even the Savings Bank Law failed to have a significant effect on the Nationalists' financial position.

Perhaps because of the government's financial situation, the largest private bank, the Bank of China, attempted to loosen its ties to the Nationalists. The Bank of China began liquidating its holdings of government bonds at a loss. Since many smaller banks tended to follow the Bank of China, the Nationalists were worried that large-scale liquidation of government bonds would follow. If the bond market collapsed, the Nationalists would be unable to continue the policy of debt financing. In desperation, the government began to look for another solution to its financial problems.

Rather than cut expenditures, the new finance minister, H. H. Kung, in consultation with Chiang Kai-shek, devised a scheme to harness the resources of the largest banks to further underwrite the Nationalist government. Instead of making the securities themselves more attractive, Kung intended to seize outright control of the two largest private banks in China, the Bank of China and the Bank of Communications.

The first step was to initiate a propaganda campaign against the bankers, essentially blaming them for China's economic problems. Kung asserted that business failures, caused by the deflation, were a result of the banks' placing their own profits above the public interest. The propaganda worked. Irate citizens voiced opposition to the banks, and Chinese newspapers ran editorials supporting Kung's charges.

Public opinion and Kung's urging persuaded the banks to establish a fund from which emergency loans would be made to ailing businesses. But Kung's concern for failing businesses was largely a front. His primary concern was the financial condition of his employer, the Nationalist government. The propaganda campaign was designed to sway public opinion in favor of government seizure of the Bank of China and the Bank of Communications.

On March 23, 1935, Kung announced that the Nationalist government would seize control of the two banks. Kung gave the takeover the appearance of legality by arbitrarily creating enough shares in each bank for the government to become the majority stockholder. Instead of using the emergency fund to aid businesses, it was used to partially pay for the shares of the banks. The rest was financed with a nominally equivalent value of government securities. Kung removed the old bank officials and replaced them with government appointees.

In June 1935, the Nationalist government used resources from the two banks to gain control of some of the smaller private banks. Kung ordered the three government banks—the Bank of China, the Bank of Communications, and the Central Bank of China—to hoard the notes of several smaller banks in Shanghai. When they had amassed a substantial quantity of the notes of the smaller banks, the three government banks simultaneously presented them for redemption. Since the banks were unable to redeem all the notes at once, Kung declared the banks to be insolvent and immediately seized control. He insisted that the government would manage them in the public interest. Again, the officials of the banks were removed and replaced with political appointees.

The End of Private Banking

By July 1935, the Nationalist government had ended private banking in China. The resources of the Chinese banks were at the Nationalists' disposal, since they held a majority interest in each bank. No time was wasted in using these resources to finance the government. The banks were directed to purchase government securities and to advance loans. But even with the resources of China's largest banks, the Nationalist government was barely able to remain solvent.

The banking coup had no effect on the deflation. Businesses continued to fail as more silver

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was smuggled out of China. In a futile attempt to stop the deflation, the Nationalists made the smuggling of silver out of China a crime punishable by death or life imprisonment.[14] Still, the deflation continued.

With the end of private banking, Kung proposed to institute a managed currency backed by nothing more than government promises. The switch to a paper currency was intended to benefit the government in two ways. First, all silver in China would come under the government's direct control. With government control of silver and the help of a "Currency Stabilization Fund" created by the United States and Great Britain, it was believed that the deflation could be stopped. Second, the government would have monopoly power over the money supply, so that it would be possible to monetize the government debt.

On November 3, 1935, the Nationalist government issued the Currency Decree.[15] Effective the next day, only notes issued by the three largest government banks—the Bank of China, the Bank of Communications, and the Central Bank of China—were to be legal tender in China. The new currency, called the *fai-pai* or Chinese National Currency, was to be managed by the Central Bank of China. The notes of private banks were allowed to continue circulating in fixed amounts, although they were to be gradually phased out. All institutions and individuals who owned silver were ordered to exchange it for the new currency within six months.[16]

To preserve confidence in the new currency, the Decree contained provisions to establish a "Currency Stabilization Fund." The Fund was to buy and sell foreign exchange in order to keep the exchange rate of the Chinese currency approximately constant relative to certain foreign currencies. The Decree also contained provisions to alter the function of the Central Bank. Instead of merely being an arm of the Nationalist Treasury, the Central Bank was to become a "banker's bank" distinct from the Nationalist Treasury.[17] Also, the Decree maintained that "plans of financial readjustment have been made whereby the National Budget will be balanced."[18] And, according to Finance Minister Kung, "The government is determined to avoid inflation. . . ."[19]

The wording of the Decree was the government's attempt to quell fears of inflation. Chinese newspapers ran editorials assuring the public that the Nationalists had nothing but the best intentions for the Chinese economy, and the move to a paper currency was heralded by economists around the world as a step toward a modern banking system. But, despite the provisions of the Decree, the Central Bank was never removed from the Treasury's control. Even more fraudulent was the assurance that the budget would be balanced. Indeed, the government deficit increased in the years following the currency reform.

In retrospect, Kung's statement seems like a cruel joke on the Chinese people. The currency reform destroyed the private banking system which had served the Chinese economy well, and placed control of the currency in the hands of a corrupt and inept government. Inflation began almost immediately. Eventually the inflation became so severe that it helped bring about the collapse of the Nationalist regime. Thus, monopoly power over the currency proved fatal to the Chinese economy, since the inflation that Kung was "determined to avoid" occurred with a severity and length unparalleled in history. □

1. Chang Kia-Ngau, *The Inflationary Spiral: The Experience in China, 1939-1950* (New York: John Wiley & Sons, 1958), p. 372.
2. Arthur N. Young, *China's Wartime Finance and Inflation: 1937-1945* (Cambridge: Harvard University Press, 1965), p. 159.
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4. *Ibid.*, p. 66.
5. Eduard A. Kann, *The History of China's Internal Loan Issues* (New York: Garland Publishing Inc, 1980), p. 82.
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12. Friedman and Schwartz, p. 490.
13. Coble, p. 171.
14. W. Y. Lin, *The New Monetary System of China* (Shanghai: Kelly and Walsh Publishers, 1936 [reprinted by the University of Chicago Press]), p. 73.
15. *Ibid.*, p. 78.
16. *Ibid.*
17. The Currency Decree of November 3, 1935.
18. *Ibid.*
19. *Ibid.*

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The International Debt Crisis

by Ken S. Ewert

Once there was a man with a large sum of money. He decided to lend a considerable portion of it to a man from a far-away country who offered him a high rate of return. But the foreigner wasted some of the money in riotous living, he was careless and allowed some of the money to be stolen, and what he did invest soon soured because of his poor investment skills. It wasn't long before he had trouble making the payments on his debt. The lender saw the debtor's poor stewardship, but not wanting to admit his own mistake in lending to the man, lent him still more money in the hopes that the debtor would begin to prosper. But the debtor continued his thriftless ways, and the lender soon found himself in serious financial trouble.

This simple story describes, by analogy, what economists call the "world debt crisis." In our parable, the lender symbolizes the several large commercial banks (American, Japanese, and European) which made substantial international loans during the 1970s and early 1980s, and the debtor represents countries such as Brazil, Mexico, and other less developed countries (LDCs) which borrowed heavily during that period. Most people understand this story as far as it goes—how the international debt problem happened. But most of us are still in the dark as to why it happened, and how this crisis is likely to be resolved.

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What Caused the Massive Debt?

By 1982 the LDCs owed over $500 billion to Western banks, governments, and international agencies. This amounted to a fivefold increase in their indebtedness during the previous decade.[1] Clearly there had been a world-wide splurge of credit. But why? Was it because of greedy bankers? Were avaricious LDC governments to blame? Both the banks in their reckless chase after profits, and the borrowing countries in their ill-advised pursuit of wealth and power, bear responsibility for the present crisis. But greed alone does not adequately explain why so many people made the same sort of error at the same time. Why did the explosion in international debt occur in the 1970s rather than the 1960s or the 1950s? Was there a reason which caused the lenders to extend credit and the debtors to accrue debt on such a grand scale?

The explanation often given for the huge loans made to LDCs during the mid and late 1970s is that the banks were recycling "petrodollars." This explanation goes as follows: In 1973 the OPEC cartel succeeded in exacting huge increases in the price paid for their oil and found themselves suddenly rich in dollars. These dollars needed to be invested, and many of them were deposited with the "money center" banks in London and New York. These banks, suddenly rich in deposits, turned around

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and invested these funds in the form of loans to the LDCs. The process was repeated in the late 1970s when OPEC again was able to increase sharply the price of oil. It was this inflow of petrodollars which gave rise to spurts of extraordinary lending in the mid 1970s and again in the latter part of the decade.

This explanation has some truth to it, but it fails to address an important issue. Why did OPEC, an obscure cartel which had been in existence for more than a decade, suddenly, in the early 1970s, find itself in a position to demand four times as many dollars as before for its product? One obvious reason for the cartel's success is that the dollars which the oil producers sought to "buy" with their oil had become more plentiful. But where did these dollars—which eventually became loans to the LDC debtor countries—come from in the first place?

Dollars are created by only one entity—the Federal Reserve System (the Fed). The inflation—the increase in the quantity of money and credit—of the late 1960s forced the Nixon administration to cut the tie between gold and the dollar in 1971. Too many dollars had been created, and the U.S. Treasury no longer had sufficient gold to redeem dollars at their declared value. With the Fed completely freed from the constraints of gold, the rest of the decade of the 1970s, on the whole, was even more inflationary. Between 1970 and 1984, the Eurodollar market (U.S. dollar deposits held in foreign countries) grew from $100 billion to nearly $2 trillion.[2]

It was this monetary expansion which precipitated the massive amount of international lending that took place in the 1970s. Banks found themselves flush with new deposits (including OPEC's petrodollars) and the money had to be invested somewhere. From the vantage point of many bankers, the developing countries seemed an excellent place to invest.

Why Loans to LDCs?

Why did the banks lend to governments and businesses in developing countries?[3] One obvious reason was the economy of scale inherent in these loans. It was much easier and potentially more profitable to make a single $100 million loan to the Mexican government as opposed to hundreds of separate loans to American developers, businesses, or homeowners. Rather than having to investigate a multitude of individual projects, a loan to the LDC meant that the LDC's government investigated (supposedly) and administered the funds to the assorted state and private borrowers. The loans also were alluring because of the guarantee (either implicit or explicit) of the LDC governments. Surely a sovereign government—always having the power to tax—would not go bankrupt.

Another attraction of these loans was the high yield which they offered. Many loans were negotiated for floating interest rates, often at rates of one-and-a-half to two per cent above LIBOR (the London Interbank Offered Rate). The fact that these loans had floating rates considerably lessened the risk of future inflation's wiping out the real value of the banks' loan assets. In contrast, domestic loans during the same period usually were negotiated at fixed rates, and were subject to interest rate ceilings and offered substantially lower rates of return.

Reasons for Borrowing

Why were the developing countries so eager to borrow? One important factor was the economic philosophy which had gained prevalence in these nations. Western "development economists" had been influential in shaping economic thought in these countries, as had the prominent Western universities which educated (directly or indirectly) many of the debtor country's most influential citizens. These development economists and prestigious universities, with few exceptions, were teaching that economic development can best be achieved through a "directed" economy. The views of Nobel Laureate Gunnar Myrdal reflect the prevailing wisdom of development economists during the 1950s and 1960s. According to Myrdal: "All special advisers to underdeveloped countries who have taken the time and trouble to acquaint themselves with the problems, no matter who they are . . . all recommend central planning as a first condition of progress."[4]

Although other development economists

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were not so blunt in their advocation of centralized planing, they were essentially in agreement with Myrdal. A group of leading development experts, writing in a volume sponsored by MIT's Center for International Studies, stated that "there are limits to the effectiveness of the private market institutions, especially where development must be accelerated. It may be necessary to plan out in advance the key pieces of a general development program."[5]

Sadly, these Western counselors had rejected the very principles which were responsible for the economic success of their own nations. Private property rights and private investment, the experts advised, stood in the way of swift economic progress. Accelerated economic growth, they said, could be accomplished only through a large-scale inflow of capital, and this inflow could be best accomplished through state borrowing. This was just what LDC prime ministers and finance ministers wanted to hear, since borrowing and planning economic development would mean new power and prestige for their governments.

Another incentive to borrow heavily was the continuing depreciation of the dollar throughout the 1970s. During much of the decade, the value of the dollar depreciated at a greater rate than the rate of interest at which the LDCs could borrow. This meant that during parts of the 1970s these loans, in effect, were at negative interest rates. In this bizarre inflationary environment, borrowers, at times, actually were being paid for borrowing.[6]

In anticipation of continuing inflation, the LDC countries borrowed expecting to repay their debts with less valuable dollars. But they were wrong. The U.S. did not continue to inflate at increasing rates, and by the close of the decade the Federal Reserve, under new chairman Paul Volcker, had begun to slow the rate of monetary growth. Interest rates in 1981-82 were approximately double the level of 1978-79 rates, and the dollar no longer was depreciating so rapidly in value. By the early 1980s, many debtors were faced with economic stagnation and greatly increased interest burdens.

What had gone wrong? Where had the "development capital" gone? The truth is that a good deal of the money had not been productively invested, but was simple squandered. A significant amount was stolen by government officials. The Mexican government of Lopez Portillo was infamous for its billion-dollar frauds and the *mordidas*—bribes—which were commonly necessary to "arrange matters" with government officials.[7] And Mexico was not unique. Several LDC leaders are among the world's wealthiest people. President Suharto of Indonesia has an estimated wealth of $3 billion, President Mobuto of Zaire owns an estimated $5 billion, and former Philippine President Marcos is believed to be worth $10 billion.[8]

Consumed by the State

More often than not, the loans were used to aggrandize the state and expand its power. During the heaviest period of lending (1976-1982), the number of state-owned businesses in Mexico was doubled.[9] The borrowed wealth allowed popular subsidy and transfer programs to flourish, and the public sphere grew at the expense of private freedom. In Mexico, for example, the portion of GNP consumed by the state virtually doubled between 1970 and 1986.[10]

To be sure, some funds were invested in bona fide capital projects. Unfortunately, these projects most often represented political and not consumer priorities. In a free economy, what is produced is ultimately decided by consumers who cast their economic "votes" for particular products or services. By buying one product and not another, they communicate their preferences. Profit-seeking producers, eager to anticipate and fulfill consumers' desires, invest capital in the appropriate industries.

The foreign loans of the 1970s, however, went primarily for capital projects chosen by the state. Such grandiose projects as the construction of the Itaipu Dam between Paraguay and Brazil, and the building of roads through the Amazon jungle, undoubtedly benefited some people and boosted the governments' popularity. However, they were not the most efficient use of capital; the same funds in the hands of free-market entrepreneurs would have been put to different uses and better satisfied

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the wants of consumers. Contrary to the hopes of the planners, the state investments did not generate the wealth necessary to repay the loans.

With triple-digit inflation, price controls, oppressive taxation, stifling regulations, and a basic disrespect for private property rights, many of the debtor nations have almost destroyed private enterprise. Rather than invest in their own countries, many individuals have converted their currencies into dollars and invested them in nations which are economically freer and more stable. This is called "capital flight." One study by a New York bank found that from 1978 to 1983, while Argentina incurred $35.7 billion in new loans, $21 billion left the country; the Philippines added $19.1 billion of new loans and $8.9 billion left the country; and Venezuela added $23 billion while its citizens spirited abroad $27 billion.[11]

This extraordinary capital flight indicates what the citizens of these nations think of their governments' policies. Fearful of their wealth's being consumed by taxation or destroyed by inflation, they convert it to hard currencies and invest abroad. It is ironic that while the LDC governments were borrowing in order to "direct" capital investment for the good of their economy, the same statist policies were driving out private capital.

Problems for Banks

When in 1982 many countries could not pay their debts, commercial banks and governmental agencies, such as the International Monetary Fund (IMF), scrambled to reschedule the loans. This involved stretching out the payment periods and decreasing the interest rates. The IMF advanced new loans to struggling debtors on the condition that the LDC governments follow certain prescribed "austerity measures." Between 1982 and 1986, billions of dollars of new short-term loans were made to enable the debtor countries to make their interest payments.[12] But this was only a band-aid solution. The banks were extending new loans not because of their confidence in the future ability of these nations to repay, but rather to avoid having loan payments declared in arrears by bank regulators. Recognizing the default of these LDC debtors would mean that many of the large banks would be "insolvent," or in more blunt terms, bankrupt.

In 1985, Treasury Secretary James Baker announced the Baker Plan to address the debt crisis. The plan called for commercial banks to extend $20 billion in new loans, and for the debtor countries to enact reforms reducing government intervention in their economies. It also called for an increase in funds and a new debt financing role for the World Bank. Under the Baker Plan, the IMF was to continue its role as the lender of last resort or "safety net" to the LDCs.

But by 1986 it was clear that the new loans and IMF rescue packages had failed to solve the debt problem. The big debtors—Brazil, Mexico, and Argentina—showed little sign of improvement, and the money-center banks with large LDC loans were facing declining credit ratings and increasing costs of borrowing from depositors. Despite arm-twisting by Federal officials, many commercial banks were becoming reluctant to make new loans.

In February 1987, Brazil, the largest international debtor, announced that it would no longer pay interest on its debt. In May of that year, Citicorp announced a record $3 billion increase in its loan-loss reserves. It was, in the words of *Business Month*, "a breathtaking public admission that the banks and the governments of the major industrial nations will never recoup the $1 trillion they are owed by developing countries."[13] Following Citicorp's leadership, several other major banks increased their loan-loss reserves in recognition of the almost certain default of a large portion of their LDC loans.

What Will Happen?

Is there any chance that more than a fraction of these loans will be repaid? One option that offers a glimmer of hope is "debt-equity swaps," in which the banks sell their loans back to the LDC country at a discount in return for local currency. The currency then is converted into equity investments in the LDC. This approach has its limitations, not the least of which is the lack of respect for private property in many of these countries (such as was exem-

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plified by the nationalization of Mexican banks in 1982). Other problems include the rampant inflation and wild currency swings which make business in an LDC difficult, and the fact that most LDCs are wary of foreign investments and place strict limitations on them.[14] To date there have been only a few billion dollars worth of debt-equity swaps, hardly a dent in the three to four hundred billion dollars owed to Western banks.

There is little question that apart from a radical and sustained change in the role of government in the LDCs, the bulk of these loans will not be repaid. Most of these countries have long since stopped paying principal and many, such as Brazil and Argentina, are in virtual default. The pertinent question now is: If the debtors won't pay, who will?[15]

Recent moves by money-center banks to increase their loan-loss reserves are a significant step toward recognizing and bearing the losses. However, even Citicorp's record increase in reserves last year only amounts to a write-off of 25 per cent of its total LDC portfolio.[16] Since the "secondary markets" currently value the LDC loans at somewhere between 45 and 55 cents on the dollar, Citicorp and other banks will likely need to make more large increases in their loan-loss reserves.[17] This may mean several years of low stock prices, difficulty in raising new equity, and high costs on borrowed funds—not a pleasant scenario for bank management.[18]

But will the losses ultimately be borne by the banks and their shareholders? There are certainly those in the banking industry who are calling for government action to "socialize" the losses, or in other words to pass them on to individual citizens. Unfortunately, it seems that this call is falling on sympathetic ears among policy makers. There is no doubt that Washington fears the ramifications of one or several large banks' failing.

One way these losses are being socialized is through monetary policy. The Fed has pursued a very loose policy since late 1984, thereby devaluing the dollar and lowering interest rates. This favors the debtor nations, making it possible for them to repay their debts with less valuable dollars. Through monetary inflation, a banking crisis may well be averted as the real value of the LDC debt is inflated away. Who pays in this scheme? All the individuals and institutions who own dollars pay. Dollar holders find the purchasing power of their savings deposits or securities eroding and their standard of living reduced.

But the extraordinary monetary ease since late 1984 has failed noticeably to help the debtor countries climb out of their hole. Bound by their addiction to paternalistic governments, they have only fallen more firmly into the grasp of debt. If these countries cannot service their debts when interest rates are low and dollars are easy to come by, there truly will be a world debt crisis when, inevitably, the Fed tightens and interest rates rise in recognition of the dollar inflation.

A second way the LDC debt is being foisted on the innocent is through lending by international agencies. Since these organizations are funded by the U.S. and other industrialized countries, new loans are really a transfer of wealth from American (and German, Japanese, etc.) citizens to the commercial banks with problem foreign loans.

During the past few years, the citizens of the industrialized countries unwittingly have picked up an increasing portion of the tab for bad LDC debts. Between 1980 and 1984, transfers via the World Bank to Latin American debtors doubled from $1.6 billion to $3.2 billion, and the Inter-American Development Bank (IADB) increased its disbursements from $1.4 billion to $2.4 billion.[19] Although these amounts are still relatively small in relation to the outstanding debt, the trend is alarming. It is quite possible that in the future, U.S. and European authorities will "socialize" larger portions of the debt through international agencies such as the World Bank, the IADB, and the IMF.

While the Federal Reserve deserves considerable blame for its role in prompting the excessive lending, we must remember that some banks did lend wisely during the credit expansion. Not every bank was willing to loan more than 100 per cent of its equity capital to Latin American countries. Morally, there is no question as to who should bear the burden of these losses. The commercial banks which entered into these loans aware of the risks should face

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the consequences of what turned out to be their imprudence. The many innocent individuals who had no part in such lending should not be forced to pay for the injudicious behavior of a few banks. □

1. Darrell Delamaide, *Debt Shock: The Full Story of the World Credit Crisis* (New York: Doubleday & Company, Inc., 1984), p. 7.

2. Hans F. Sennholz, *Money and Freedom* (Springs Mill, Pa.: Libertarian Press, Inc., 1985), p. 5.

3. At the September 1980 meeting of the International Monetary Fund and the World Bank, the competition to invest in LDCs was such that on some occasions "bankers were literally chasing prime ministers and finance ministers around hotel lobbies in a desperate effort to outlend their rivals." John H. Makin, *The Global Debt Crisis: America's Growing Involvement* (New York: Basic Books, Inc., 1984), p. 5.

4. Gunnar Myrdal, *An International Economy* (New York: Harper and Brothers, 1956), p. 201, quoted in Paul Craig Roberts, "Third World Debt: Legacy of Development Experts," *The Cato Journal* Vol. 7, No. 1, Spring/Summer 1987, p. 232.

5. Max F. Millikan and Donald L. Blackmer, eds., *The Emerging Nations: Their Growth and United States Policy* (Boston: Little, Brown and Co., 1961), quoted in Roberts, p. 233.

6. During the inflation of the 1970s "the interest rates at which Eastern Bloc nations and LDCs borrowed were generally below the U.S. inflation rate. As a result, the real cost of carrying external debt was negative during this period." Robert Weintraub, "International Debt Crisis and Challenge," *The Cato Journal* Vol. 4, No. 1 (Spring/Summer 1984), p. 28.

7. George Byram Lake, "Nothing Left to Steal," *National Review,* July 3, 1987, p. 40.

8. George B. N. Ayittey, "The Real Foreign Debt Problem," *The Wall Street Journal,* April 8, 1986, p. 30.

9. Lake, p. 41.

10. *The Heritage Foundation Backgrounder,* "A U.S. Strategy To Solve Mexico's Debt Crisis," July 17, 1986.

11. Ayittey, p. 30. According to one estimate involving eight highly indebted LDCs as a group, for the period of 1974-1982, for every U.S. dollar that was lent, 30 cents left the countries. Mohsin S. Khan and Nadeen Ul Haque, "Capital Flight From Developing Countries," *Finance & Development,* Vol. 24, No. 1 (March 1987), pp. 3-4.

12. Total debt for LDCs rose approximately 25 per cent between 1982 and 1986.

13. Edward Mervosh, "Unspeakable Debts, Unthinkable Answers," *Business Month,* October 1987, p. 56.

14. Of the big debtors, only Chile has fully embraced the concept of debt-equity swaps. Argentina requires investors to invest an additional dollar for every dollar of debt they swap for foreign currency. Mexico restricts foreign ownership to "non-strategic areas" such as tourism, and Brazil has prohibited foreign investment in its computer industry. Peter Truell and Charles F. McCoy, "Third World Creditors Give Debt-Equity Swaps a Try," *The Wall Street Journal,* June 11, 1987, p. 6.

15. The proposal unveiled by Mexico on December 29, 1987 has been hailed by some within the financial community as "innovative" and a "major breakthrough" in managing Mexico's debt crisis. According to this plan, Mexico will issue $10 billion of new marketable bonds which will be collateralized by a zero-coupon U.S. Treasury Bond (which will be purchased for $2 billion and will have a maturity, in 20 years, of $10 billion). Mexico will swap its newly created bonds—at a discount—for those currently held by its creditors. Under this plan, only the principal of the bond will be collateralized by the zero-coupon Treasury bond. The interest payments are not collateralized and remain backed only by the "full faith and credit" of Mexico. Also, the discount which Mexico has indicated it would like (50 per cent) would require a substantial write-down of assets for the participating banks—a larger loss than many of the banks can absorb. Many of the major U.S. lenders to Mexico have indicated they won't take part in the plan. Wendell Wilkie Gunn, "Mexico's Old Bonds in New Bottles," *The Wall Street Journal,* January 14, 1988, p. 26.

16. Mervosh, p. 56.

17. Regional banks, which have not lent so heavily in the LDC loan market, are in better shape to weather defaults. Many of the regionals have loan-loss reserves of 50 per cent of their Latin American loans. Jeff Bailey, and G. Christian Hill, "Regional Banks May Be Eager For Mexican Plan," *The Wall Street Journal,* December 31, 1987, p. 2.

18. It's obvious that in recent months bond investors have taken a grim view of the large money-center banks. Investors, in some cases, are turning the securities into "de facto junk bonds." The average yield of single-A notes issued by money-center banks has risen to a 1.5 per cent premium over Treasury issues during recent months (from less than 1 per cent). Matthew Winkler, "Some Banks' Debt Is Behaving Like Junk," *The Wall Street Journal,* February 2, 1988, p. 16.

19. Richard E. Feinberg, "Latin American Debt: Renegotiating the Adjustment Burden," *Columbia Journal of World Business,* Fall 1986, p. 23.

Resolving the Crisis

IDEAS ON LIBERTY

Policies of interventionism and socialism tend to immobilize the population and capital of the world, thus bringing about or maintaining the world divergencies of productivity, of wealth and income. A government that nationalizes efficient industries producing for the world market and then mismanages them not only hurts the interests of its own people but also those of other nations living in a world community.

These international conflicts are inherent in the systems of interventionism and socialism and cannot be solved unless the systems themselves are abolished. The principles of national welfare as conceived by our progressive planners conflict with the principles of international cooperation and division of production.

—HANS F. SENNHOLZ
How Can Europe Survive?

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A REVIEWER'S NOTEBOOK

Revolution

by John Chamberlain

Martin Anderson, who is now a senior fellow of the Hoover Institution in California, worked for Ronald Reagan for more than seven years. He went through three presidential campaigns with Reagan, traveled with him to two Republican conventions, and spent considerable time in the White House helping to formulate the policy that has resulted in the so-called supply-side tax cuts. He knew Reagan as Larry Speakes, Don Regan, and Michael Deaver never knew him.

His book about the Reagan years, *Revolution* (New York: Harcourt Brace Jovanovich, 467 pp., $19.95), takes long views. Anderson did not approve of the Iran-Contra episode, which had American arms going to the Ayatollah, with profits to the Contras, but he thinks Reagan was the victim here of bad advice from William Casey, who was suffering from a brain tumor that made him an unreliable counselor.

In the long view, says Anderson, the Iran-Contra business will not bulk very large. The Reagan revolution, as Anderson sees it, must make allowance for occasional mistakes of judgment. What counts is the movement itself. It transcends personalities. What Anderson calls the "new capitalism" will continue to grow no matter who wins office in the 1988 elections.

Looking back over the past quarter century, Anderson asks what it is that links Barry Goldwater, Richard Nixon, and Ronald Reagan together. "What," he writes, "threw them high on the rocky beach of American politics? . . . Was their power due to their overwhelming personalities, to personal characteristics that will never be duplicated? Or was it due to something independent of any one person, to intellectual and political currents that produced first Goldwater, then Nixon, then Reagan?"

Anderson answers his own rhetorical questions by indirection. Barry Goldwater's smile, Richard Nixon's jabbing forefinger, and Ronald Reagan's friendly wave of the arm were hardly causative factors. "So far," says Anderson, "no one has attributed the move toward capitalism in China, and the Soviet Union, and New Zealand, and in dozens of other countries throughout the world, to the rise of these three personalities."

An intellectual revolution, says Anderson, has occurred worldwide. There may be a lull in America after Reagan's retirement in 1989, but "Communism, socialism, and any other form of dictator statism have proven to be intellectually bankrupt. The only vibrant, thriving political philosophy with a sound intellectual base remaining is capitalism. . . . Only when and if there is a seismic shift to the left in the intellectual world will we see a reversal of the political changes we are now witnessing."

Anderson thinks it is important to emphasize

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that Ronald Reagan majored in economics at Eureka College in Illinois before the onset of the depression of the Thirties. "The economics he was taught," says Anderson, "was the old classical variety, straight from the works of Adam Smith, Alfred Marshall, Irving Fisher, Eugen Boehm-Bawerk, David Ricardo, and Jean Baptiste Say. John Maynard Keynes had not yet written the *General Theory*. Few complicated mathematical models were used for the exposition of economic theory; instead, the old economics relied on words, using the English language to explain basic principles."

Anderson himself relied on words when he undertook to formulate policy for Reagan in August of 1979. He was not impressed with the idea that there was a necessary trade-off between inflation and unemployment. The problem as he saw it was to reduce inflation and stimulate economic growth without, as he says, "having an economic bellyache." Economic growth would follow if Federal taxes were reduced from a point so high that it stifled the incentives for individuals to earn, save, and invest.

Anderson advocated a program of three years' duration of across-the-board tax cuts, especially in the higher, incentive-destroying marginal rates. The Kemp-Roth tax cut legislation was in accord with Anderson's advice to Reagan. Just to touch all bases, Reagan listened to a total of 74 economic advisers during the 1980 campaign. "Reaganomics," says Anderson, "came directly out of the heart of the Republican economic establishment of the United States. It represented the thinking of some of the best economic minds in the world."

The proof of the pudding is, of course, in the eating. During the five years between November 1982 and October 1987, says Anderson, "more wealth and services were produced than in any like period in history. There were 59 straight months of uninterrupted economic growth. . . . Over 13 million new jobs were created. . . . By the end of 1987 the United States was producing about seven and one-half times more every year than it produced the last year John F. Kennedy was President . . . the U.S. economy is now an economic colossus of such size and scope that we have no effective way to describe its power and reach."

Yet Martin Anderson concedes that the Federal deficits we have been running are too high. The trade deficit is worrisome, and too many Federal regulations remain unreformed. Reagan, he says, cannot expect credit for a perfection that is still elusive.

An Economic Bill of Rights

As far back as 1984, Anderson wrote an Economic Bill of Rights in which he called for a single amendment to the Constitution with five sections. *One,* he would limit the amount the federal government can spend. *Two,* he would require that the Federal budget be balanced. *Three,* he would prohibit wage and price controls. *Four,* he would give a line-item veto power to the President. And *Five,* he would require a two-thirds vote of Congress on all major spending bills.

Such a five-fold Constitutional amendment will obviously have to wait in an election year. But 31 states have endorsed the basic idea of the amendment, and it will surely be a prime subject for argument under either a Bush or a Dukakis regime.

Anderson's book got little of the publicity that went to Don Regan's. Anderson's own references to Don Regan are hardly flattering. "The thing that most disturbed me," he writes, "was the whispered word from one of my colleagues that Donald Regan donated a substantial amount of money to President Carter's campaign in 1980 as well as to Reagan's. Anybody who could contemplate supporting the economic policies of both Carter and Reagan earned a skeptical eye for at least a while."

Despite the emperor-wears-no-clothes revelations of Don Regan, Larry Speakes, and Michael Deaver, Anderson is certain that what Reagan and his comrades have done "is to shape America's policy agenda well into the twenty-first century. The prospects are nil for sharply progressive tax rates and big new social welfare programs."

Even though "Revolution" may be too strong a word to invoke here, the Reagan years at least represent a divide. □

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PERESTROIKA: NEW THINKING FOR OUR COUNTRY AND THE WORLD
by Mikhail Gorbachev

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Reviewed by William H. Peterson

Vigilance. National defense. Ideological power. Gamesmanship. These are the qualities that former President Richard Nixon—the man whom Nikita Khrushchev told "We will bury you"—counsels America to adopt in "Dealing with Gorbachev," his article in *The New York Times Magazine* last March.

The counsel is timely. For with *glasnost,* the new Soviet style of light and openness, with the new Intermediate-Range Nuclear Forces (INF) Treaty and Strategic Arms Reduction Talks (START) with the Soviet Union, and now with *perestroika,* the new Soviet policy of restructuring its economy and the title of a revealing if not subtly propagandistic book by 57-year-old General Secretary Mikhail Gorbachev, America is seemingly dealt a new hand by a shrewd and dapper poker player.

But is it really a new hand? I recall the New Economic Policy (NEP) of Lenin who, in 1921, so as to gain Western support and stem scarcity and popular unrest, allowed small businesses to operate privately and independent farmers to sell some of their produce at a profit. Stalin squelched NEP and launched the first Soviet Five-Year Plan in 1928. The rest, as is said, is history.

Today, however, renewed scarcity and at least some popular unrest, especially amid Soviet ethnic nationalities such as the Armenians, continue to dog the Soviet planners. Too, the planners are undoubtedly impressed and concerned by the economic headway made by the Red Chinese who, under the leadership of Deng Xiaoping, began to adopt some Western market techniques in 1976 after the death of Mao. And so now *perestroika* is prescribed for the USSR.

Gorbachev confesses that under recent Soviet communism:

> It became typical of many of our economic executives to think not of how to build up the national asset, but of how to put more material, labor and working time into an item to sell it at a higher price. Consequently, for all "gross output," there was a shortage of goods. We spent, in fact we are still spending, far more on raw materials, energy and other resources per unit of output than other developed nations. Our country's wealth in terms of natural and manpower resources has spoilt, one may even say, corrupted, us.

The confession goes on. Gorbachev complains that though the Soviet Union is the world's biggest producer of steel, raw materials, fuel, and energy it still has serious shortfalls in them "due to wasteful or inefficient use." Hard-currency earnings are depleted by having to import millions of tons of foreign grain when pre-Revolution Russia was the world's greatest grain exporter.

Gorbachev tells us his rockets can find Halley's comet and fly to Venus with amazing accuracy, yet "many Soviet household appliances are of poor quality." He concedes that at some administrative levels there emerged a disrespect for law and encouragement of "eyewash and bribery, servility and glorification," even "criminal acts." Widespread perplexity and indignation welled up in the population so that "the great values of the October Revolution and heroic struggle for socialism were being trampled underfoot."

Problems snowballed faster than they were resolved, Gorbachev further concedes. He says: "This, unfortunately, is not all. A gradual erosion of the ideological and moral values of our people began." The national problems of alcoholism (including moonshining), drug addiction, and crime are cited.

Thus was the Soviet Union by the first half of the 1980s "verging on crisis." This conclusion was announced at the Plenary Meeting of the Central Committee of the Soviet Communist Party in April 1985. Then the Soviet leaders, headed by Mikhail Gorbachev who had been named General Secretary only the month before, attacked the "spend-away" economy in which managers achieved "growth" through

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construction of new plants and employment of more workers without reference to effective demand.

They similarly condemned the "gross-output" planning and production approach which stresses "weight" and "quantity" of goods, again without reference to market requirements including quality and cost control. The upshot was, as noted, installation of the momentous policy of *perestroika*—the restructuring of the Soviet economy. Broadly applied at home and abroad, says the General Secretary, perhaps with a twinkle in his eye, *perestroika* could lead to a "nuclear-free, non-violent world." Sure.

Yet details of *perestroika* are anything but spelled out. Yes, he notes that a key Law on State Enterprise has been adopted in which orders are imposed on industrial executives to align supply with demand. State businesses must henceforward, for example, engage in cost accounting. They must engage in vigorous competition.

But, says Gorbachev, we refuse to give up the planned economy. So he still speaks of "socialist planning," "socialist competition," and even "the socialist market"—however self-contradictory the phrase.

We reject the capitalist model of the West, he declares, adding that, properly implemented, "socialism can achieve much more than capitalism."

But does the rejection make sense? Are ends and means in harmony?

Or, is Mikhail Gorbachev trying to save face in this extraordinary book, to save but the trappings of socialism? Or, is he, like Lenin and the NEP before him, simply trying to buy time, to retreat two steps now so as to advance three steps later? I don't know the answers to the last couple of questions.

I do know, however, following Ludwig von Mises' 1922 classic, *Socialism,* that a centrally planned economy isn't a viable system. Without limited government and private property, socialist planners can't perform "economic calculation"—the use of market prices, including relative prices and derivative prices, to coordinate and enhance roundabout production. Without true market prices, in other words, socialism flies blind.

In any event, Nixon's entreaty for America makes sense: *En garde.* □

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